ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

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ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

WEDNESDAY, MARCH 17, 1982

U.S. SENATE,
SENATE FINANCE COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 9:09 a.m. in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Danforth, Grassley, Long, Byrd, and Bradley.

The CHAIRMAN. Well, we are pleased to have Senator Weicker, Senator Stevens, Senator D'Amato, and Senator Tsongas appear before the hearing this morning. I apologize for being a bit late. We had a breakfast meeting with Arthur Burns to try to see how to bring order out of chaos. And it took longer than we expected.

I assume that you each have a prepared statement. Each will be made part of the record. I know that you are extremely busy so we would be very happy if you could summarize your statements, so that you can move on to your next responsibility. [Laughter.]

Senator Weicker.

Senator WEICKER. Why don't I defer. Senator D'Amato informs me that he is leading the St. Patrick's Day parade in New York. And for those that find that as a dichotomy, I can only say that I can march in Columbus Day parades in Connecticut, he can march in St. Paddy's day parade in New York.

The CHAIRMAN. Senator D'Amato.

STATEMENT OF HON. ALFONSE D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Thank you very much, Mr. Chairman, Senator Weicker, Senator Stevens, and members of the committee. I ask that the entirety of my text be included in the record as if read. I'll just try to summarize some of the highlights of the testimony dealing with industrial revenue bonds, the program which has been most effective in my State and, I think nationally. The Treasury proposals would not just limit IDB's, but would really lead to their abolition. I don't believe that this should be allowed to happen.

The use of IDB's has had a very profound effect on small business activity throughout our Nation. And when we have an opportunity to meet the needs of small business, particularly during these times of unduly high interest rates, we should not renig on our commitments. I think it's important that industrial development bonds be continued.

To illustrate with some statistics from my own State of New York, from 1970 to 1980, the first 11 years in which IDB's were issued in New York, 658 projects were financed under section 103(b)(6); $1.3 billion in bonds were issued for a project average of less than $2 million. It is not the giant concerns that have been utilizing them, but rather the small manufacturers, et cetera.

IDB's were authorized by 85 different local agencies. Of the $1.3 billion of affordable financing made available through issuance of IDB's, $721 million was used for industrial purposes, $315 million was used for commercial purposes and $269 million was used for pollution control. IDB's facilitated the creation or retention of more than 80,000 jobs during this period. In addition—and I think this is the statistic that is most important—it is estimated that another 0.65 jobs are created elsewhere in neighboring support businesses for every one of those 80,000 plus jobs. New York gained $1,200 in State taxes for each new job created and from $1,000 to $2,000 additionally in local taxes. When these figures from just one State are extrapolated to the rest of the Nation, the benefits for economic development and employment opportunities, and State and local financing resulting from IDB's are undeniable.

I reiterate. I don't believe that we can eliminate this program. According to the Congressional Budget Office the section 103(b)(6) IDB program is largely a small business program. Of the over $8 billion of IDB's issued in 1980, 84 percent of the capital went to small- and medium-sized businesses. Thus, the choice is simple. If we support high interest rates for small businesses, we should support the administration's proposal. If, on the other hand, we believe that small firms face special problems in the competitive marketplace that deserve time honored solutions allowing them to gain access to affordable credit, then we should disagree and support my colleagues on this panel who feel that the retention of IDB's is absolutely essential to small businesses. Small businesses deserve our support. As statistics in my prepared testimony document, they have been the major creators of new jobs; and new technology. More than 50 percent of the technology that is developed in this country comes from small businesses.

Given this impressive list of accomplishments by America's small businesses in terms of jobs and in terms of gross national product, et cetera, I think we cannot avoid meeting the special needs that small businesses have today in the face of ridiculously high interest rates.

The IDB program goes back to 1935 and was codified some 14 years ago. This has been one of the most successful tax expenditures Congress has ever inserted in the Internal Revenue Code.

Now some have argued that IDB's have to be restricted because they result in excessive Federal revenue loss. I don't subscribe to that. IDB's generate new economic activity and new jobs. Their net effect, therefore is to increase Federal revenue as additional corporate and individual income taxes are collected on the increased profits and earnings resulting from this growth in economic activity. Payments for unemployment benefits are reduced. Even if these feedback activities are not considered, however, the revenue gains from Treasury IDB's proposals are minimal at best.

Some claim that municipalities have difficulty selling their own revenue bonds due to competition for funds with IBD's. I suggest that if this were the case, the local governmental authorities, State and county, would abandon the utilization of IDB's. But that is not the case. IDB's have little effect on the borrowing cost of States, counties, and municipalities. The county executives who have testified on the October 5 hearing of the Urban and Rural Economic Development Subcommittee of the Small Business Committee made this point quite persuasively. Vermont Governor, Richard Snelling, appearing on behalf of the National Governor's Association, echoed their sentiments. Purchasers of industrial development bonds are different from those who invest in general obligation bonds. The two types of investments do not compete against each other in the same marketplace.

The corollary argument that the issuance of tax-exempt IDB's dries up available credit for taxable conventional loans is similarly ludicrous when compared with the potential devastating effect on the credit market of all-savers certificates and the forecasted Federal deficit. Conventional credit seems to be more than readily available to large companies such as DuPont, Sears, Roebuck & Co., United States Steel, and Mobil Oil, which have tied up billions of dollars in their takeover bids. It is small business that now finds capital unattainable. We must preserve the IDB program for their use.

Another argument sometimes used against IDB's is that their benefits flow almost entirely to middlemen, such as bond counsels and underwriters. Now this is simply not true. Transaction costs for small issue IDB's are comparable with the 4- to 7-percent fees now charged by banks for conventional commercial loans.

The arguments against the continued use of IDB's are baseless. The arguments in their favor are overwhelming. With other programs for small business, including EDA, UDAG, SBA, et cetera, being cut to the bone, this tool of local economic development must be kept open to local and State decisionmaking. This is the essence of federalism. If we are going to talk about federalism, then State and local officials should be allowed to keep this essential tool.

Mr. Chairman, I'm going to ask that the balance of my remarks be included in the record. But, in closing, I would like to say that tax expenditures as successful as the IDB programs should not be sacrificed on the alter of revenue enhancement. We cannot do this to our State and local governments. We cannot do this to the small business community. And we should not do this to the American economy.

Mr. Chairman, I thank you for giving us the opportunity of presenting our feelings, our very strong feelings, in this matter. And I believe very sincerely that this has been one of America's most successful programs in helping the small business entrepreneur and, particularly, helping local governmental officials dealing with the erosion of their tax base and the movement of industrial plants and commercial activity.

And I would say that there have been very dramatic overstatements of IDB abuses. We hear about the pornographic book stores that are opened up and the disco parlors that are opened up. However, if we take a careful look, it is rather difficult to find such abuses. There may have been one or two examples, but that is all.

On the other hand, there are tens of thousands of businesses that have been helped by IDB's. Hundreds of thousands of jobs throughout this Nation have been created that would not have been created if we did not have IDB's. Hundreds of thousands of jobs throughout this Nation have been created that would not have been created if we did not have IDB's. So I would hope that the Chairman would look upon this issue with a view towards keeping this program in place.

The **CHAIRMAN**. Thank you very much, Senator D'Amato. We appreciate your statement. We may have questions, but I know you have to leave so we will save those for your colleagues, I guess.

Senator **D'AMATO**. Thank you very much.

The **CHAIRMAN**. Thank you.

[The prepared statement of Senator D'Amato follows:]

3/17/82

STATEMENT
BY
SENATOR ALFONSE D'AMATO
ON
INDUSTRIAL DEVELOPMENT BONDS
BEFORE THE
SENATE FINANCE COMMITTEE

THE REVENUE ENHANCEMENT PACKAGE ISSUED BY TREASURY ON FEBRUARY 26, 1982, CONTAINED A LENGTHY SECTION ON TAX-EXEMPT REVENUE BONDS. A NUMBER OF RESTRICTIONS WERE SUGGESTED, ANY ONE OF WHICH MIGHT BE SUFFICIENT TO COMPLETELY KILL THE INDUSTRIAL DEVELOPMENT BOND (I.D.B.) PROGRAM.

THIS CANNOT BE ALLOWED TO HAPPEN. DURING THE PAST DECADE THE SMALL ISSUE I.D.B. PROGRAM, UNDER SECTION 103(B)(6) OF THE INTERNAL REVENUE CODE, HAS BEEN A VITAL TOOL OF LOCAL ECONOMIC DEVELOPMENT. THOUSANDS OF SMALL BUSINESSES ACROSS THE NATION WOULD HAVE BEEN UNABLE TO SECURE THE NECESSARY CAPITAL FOR EXPANSION WITHOUT I.D.B.s.

TENS OF THOUSANDS OF EXISTING JOBS WOULD HAVE BEEN LOST WITHOUT I.D.B.s AND TENS OF THOUSANDS OF NEW JOBS WOULD NOT HAVE BEEN CREATED. STATE AND LOCAL TAX BASES WOULD HAVE ERODED AND AN INDETERMINABLE AMOUNT OF ECONOMIC ACTIVITY WOULD HAVE BEEN LOST. WITH TODAY'S CONTINUED HIGH INTEREST RATES, SMALL BUSINESSES CANNOT THRIVE, OR EVEN SURVIVE, WITHOUT THE LOW COST FINANCING MADE AVAILABLE THROUGH INDUSTRIAL DEVELOPMENT BONDS.

TO ILLUSTRATE WITH SOME STATISTICS FROM MY OWN STATE OF NEW YORK: FROM 1970-1980, THE FIRST 11 YEARS IN WHICH I.D.B.s WERE ISSUED IN NEW YORK, 658 PROJECTS WERE FINANCED UNDER SECTION 103 (B)(6). $1.3 BILLION DOLLARS IN BONDS WERE ISSUED, FOR A PROJECT AVERAGE OF LESS THAN $2 MILLION. I.D.B.s WERE AUTHORIZED BY 85 DIFFERENT LOCAL AGENCIES. OF THE $1.3 BILLION OF AFFORDABLE FINANCING MADE AVAILABLE THROUGH ISSUANCE OF I.D.B.s, $721 MILLION WAS USED FOR INDUSTRIAL PURPOSES, $315 MILLION WAS USED FOR COMMERCIAL PURPOSES AND $269 MILLION WAS USED FOR POLLUTION CONTROL. I.D.B.s FACILITATED THE CREATION OR RETENTION OF 80,666

JOBS DURING THIS PERIOD. IN ADDITION, FOR EVERY JOB CREATED DIRECTLY IN I.D.B. FINANCED ENTERPRISES, IT IS ESTIMATED THAT ANOTHER .65 OF A JOB WAS CREATED ELSEWHERE IN NEIGHBORING SUPPORT BUSINESSES. NEW YORK GAINED $1,200 IN STATE TAXES FOR EACH NEW JOB CREATED AND FROM $1,000 TO $2,000 IN ADDITIONAL LOCAL TAXES PER JOB.

WHEN THESE FIGURES FROM JUST ONE STATE ARE EXTRAPOLATED TO THE REST OF THE NATION, THE BENEFITS FOR ECONOMIC DEVELOPMENT, EMPLOYMENT OPPORTUNITIES AND STATE AND LOCAL FINANCE RESULTING FROM I.D.B.s ARE UNDENIABLE. I REITERATE, WE CANNOT ELIMINATE THIS PROGRAM.

ACCORDING TO THE CONGRESSIONAL BUDGET OFFICE, THE SECTION 103(B)(6) I.D.B. PROGRAM IS LARGELY A SMALL BUSINESS PROGRAM. OF THE OVER $8 BILLION OF I.D.B.s ISSUED IN 1980, 84% OF THE CAPITAL WENT TO SMALL AND MEDIUM SIZED BUSINESSES. THUS, THE CHOICE IS SIMPLE. IF YOU SUPPORT HIGH INTEREST RATES FOR SMALL BUSINESSES, YOU SHOULD SUPPORT THE ADMINISTRATION'S PROPOSALS. IF, ON THE OTHER HAND, YOU BELIEVE THAT SMALL FIRMS FACE SPECIAL PROBLEMS IN THE COMPETITIVE

MARKETPLACE THAT DESERVE TIME-HONORED SOLUTIONS ALLOWING THEM TO GAIN ACCESS TO AFFORDABLE CREDIT, THEN YOU SHOULD AGREE WITH ME AND MY COLLEAGUES ON THIS PANEL. THE ADMINISTRATION'S PROPOSALS ON TAX-EXEMPT FINANCING MUST BE RESISTED, BOTH INDIVIDUALLY AND IN TOTO.

SMALL BUSINESS DESERVES OUR SUPPORT. SMALL BUSINESSES CONSTITUTE 97% OF ALL FIRMS IN THIS COUNTRY. THEY ACCOUNT FOR 43% OF THE GROSS NATIONAL PRODUCT, 73% OF RETAIL SALES, 76% OF CONSTRUCTION DOLLAR VOLUME AND 58% OF PRIVATE NON-AGRICULTURAL EMPLOYMENT. AN M.I.T. STUDY HAS SHOWN THAT 87% OF ALL NEW EMPLOYMENT IN THIS COUNTRY IS GENERATED BY SMALL BUSINESSES. AND AN OFFICE OF MANAGEMENT AND BUDGET STUDY HAS SHOWN THAT 50% OF ALL MAJOR TECHNOLOGICAL BREAKTHROUGHS IN THIS COUNTRY ARE MADE BY SMALL COMPANIES.

GIVEN THIS IMPRESSIVE LIST OF ACCOMPLISHMENTS BY AMERICA'S SMALL BUSINESSES, WE CANNOT IGNORE THEIR SPECIAL NEEDS. PERHAPS THE MOST IMPORTANT OF THESE NEEDS IS CAPITAL FOR EXPANSION. LARGE FIRMS HAVE MUCH MORE READY ACCESS TO THE FINANCIAL MARKETPLACE THAN SMALL COMPANIES. IT IS ONLY THROUGH PROGRAMS SUCH AS INDUSTRIAL DEVELOPMENT

BONDS THAT WE HAVE, AT LEAST PARTIALLY, OFFSET THIS IMBALANCE. WE SHOULD NOT RETREAT FROM LONG ESTABLISHED PROGRAMS THAT HAVE WORKED SO WELL.

THE I.D.B. PROGRAM IS A TIME HONORED SOLUTION TO SMALL BUSINESS CAPITAL NEEDS. ITS USE DATES BACK TO 1935 AND WAS CODIFIED AS SECTION 103(B)(6) 14 YEARS AGO. THIS IS ONE OF THE MOST SUCCESSFUL TAX EXPENDITURES CONGRESS HAS EVEN INSERTED IN THE INTERNAL REVENUE CODE.

SOME HAVE ARGUED THAT I.D.B.s HAVE TO BE RESTRICTED BECAUSE THEY RESULT IN EXCESSIVE FEDERAL REVENUE LOSS. THIS IS NONSENSE. I.D.B.s GENERATE NEW ECONOMIC ACTIVITY AND NEW JOBS. THEIR NET EFFECT IS, THEREFORE, TO INCREASE FEDERAL REVENUE AS CORPORATE AND INDIVIDUAL INCOME TAXES ARE COLLECTED ON THE INCREASED PROFITS AND EARNINGS RESULTING FROM THIS GROWTH IN ECONOMIC ACTIVITY. PAYMENTS FOR UNEMPLOYMENT BENEFITS ARE ALSO REDUCED. EVEN IF THESE FEEDBACK EFFECTS ARE NOT CONSIDERED, HOWEVER, THE REVENUE GAIN FROM TREASURY'S I.D.B. PROPOSALS ARE MINIMAL. FOR THE ENTIRE TAX-EXEMPT BOND PROGRAM

PROPOSALS CONTAINED IN THEIR FEBRUARY 26 RELEASE THE ANTICIPATED STATIC REVENUE GAIN IS ONLY $6.5 BILLION OVER THE NEXT FIVE YEARS, AND I.D.B.s ARE ONLY ONE OF FIVE PROGRAMS INCLUDED IN THIS CATEGORY. THE REVENUE LOSS FEAR IS A PHANTOM ARGUMENT FOR RESTRICTING I.D.B.s.

OTHERS HAVE ARGUED THAT I.D.B.s SHOULD BE CURTAILED BECAUSE THEY INTERFERE WITH THE ABILITY OF STATES AND MUNICIPALITIES TO SELL THEIR OWN BONDS. THIS TOO IS A RIDICULOUS ARGUMENT. IF STATE AND LOCAL GOVERNMENTS REALLY BELIEVED THIS, THEY WOULD VOLUNTARILY STOP THE USE OF I.D.B.s. ALL I.D.B.s ARE AUTHORIZED AT THE LOCAL, AS OPPOSED TO THE FEDERAL, LEVEL. THE CONTINUED USE OF I.D.B.s, THEREFORE, ATTESTS VERY WELL TO THE POPULARITY OF THESE TOOLS FOR LOCAL ECONOMIC DEVELOPMENT AMONG STATE AND LOCAL OFFICIALS.

I.D.B.s HAVE LITTLE EFFECT ON THE BORROWING COSTS OF STATES, COUNTIES AND MUNICIPALITIES. COUNTY EXECUTIVES WHO TESTIFIED AT AN OCTOBER 5 HEARING OF THE URBAN AND RURAL ECONOMIC DEVELOPMENT SUBCOMMITTEE OF THE SENATE SMALL BUSINESS COMMITTEE MADE THIS POINT

QUITE PERSUASIVELY. VERMONT GOVERNOR RICHARD SNALLING, APPEARING ON BEHALF OF THE NATIONAL GOVERNORS ASSOCIATION, ECHOED THEIR SENTIMENTS. PURCHASERS OF INDUSTRIAL DEVELOPMENT BONDS ARE DIFFERENT FROM THOSE WHO INVEST IN GENERAL OBLIGATION BONDS. THE TWO TYPES OF INVESTMENT DO NOT COMPETE AGAINST EACH OTHER IN THE SAME MARKET.

THE COROLLARY ARGUMENT THAT THE ISSUANCE OF TAX-EXEMPT I.D.B.s DRIES UP AVAILABLE CREDIT FOR TAXABLE CONVENTIONAL LOANS IS SIMILARLY LUDICROUS WHEN COMPARED WITH THE POTENTIALLY DEVASTATING EFFECT ON THE CREDIT MARKET OF ALL SAVERS CERTIFICATES AND THE FORECASTED FEDERAL DEFICIT. CONVENTIONAL CREDIT SEEMS TO BE MORE THAN READILY AVAILABLE TO LARGE COMPANIES SUCH AS DUPONT, SEARS-ROEBUCK, U.S. STEEL AND MOBIL OIL WHICH HAVE TIED UP BILLIONS OF DOLLARS IN THEIR TAKE-OVER BIDS. IT IS THE SMALL BUSINESS THAT NOW FINDS CAPITAL UNATTAINABLE. WE MUST PRESERVE THE I.D.B. PROGRAM FOR THEIR USE.

ANOTHER ARGUMENT SOMETIMES USED AGAINST I.D.B.s IS THAT THEIR BENEFITS FLOW ALMOST ENTIRELY TO MIDDLEMEN SUCH AS BOND COUNSELS AND UNDERWRITERS. THIS IS SIMPLY NOT TRUE. TRANSACTION COSTS FOR

SMALL ISSUE I.D.B.s ARE COMPARABLE WITH THE 4% TO 7% FEES NOW CHARGED BY BANKS FOR CONVENTIONAL COMMERCIAL LOANS.

THE ARGUMENTS AGAINST THE CONTINUED USE OF I.D.B.s ARE BASELESS. THE ARGUMENTS IN THEIR FAVOR ARE OVERWHELMING. WITH OTHER PROGRAMS FOR SMALL BUSINESS, INCLUDING E.D.A., U.D.A.G., S.B.A., ETC., BEING CUT TO THE BONE, THIS TOOL OF LOCAL ECONOMIC DEVELOPMENT MUST BE KEPT OPEN TO LOCAL AND STATE DECISION-MAKING. THIS IS THE ESSENCE OF FEDERALISM.

WHAT ARE THESE ONEROUS AND UNACCEPTABLE PROPOSALS THE ADMINISTRATION HAS MADE CONCERNING I.D.B.s? FOREMOST AMONG THEM IS THE REQUIREMENT THAT, AFTER 1985, ALL I.D.B.s WOULD HAVE TO BE EITHER GUARANTEED BY THE FULL FAITH AND CREDIT OF A STATE OR LOCAL GOVERNMENT (IN OTHER WORDS, MAKING THEM NO DIFFERENT THAN GENERAL OBLIGATION BONDS -- G.O.s) OR ANY STATE OR LOCAL GOVERNMENT AUTHORIZING AN I.D.B. WOULD HAVE TO GIVE THE BORROWER 1% OF THE FACE VALUE OF THE I.D.B. AS A CASH GRANT OUT OF THE PUBLIC TREASURY OR ADDITIONAL TAX ABATEMENT OR REDUCED COST MUNICIPAL SERVICES, OVER AND ABOVE ANYTHING THAT IS ALREADY

PROVIDED. TO TRANSFORM I.D.B.s INTO G.O.s IS TO ELIMINATE I.D.B.s. TO REQUIRE THESE 1% MATCHING GRANTS FROM STATE OR LOCAL GOVERNMENTS IS IMPOSSIBLE. TO BEGIN WITH, GOVERNMENTS IN THE NORTHEAST AND MIDWEST SIMPLY DO NOT HAVE THE CAPITAL AVAILABLE FOR SUCH MATCHING GRANTS. I.D.B.s WOULD BECOME SOLELY A SUNBELT PROGRAM. SECONDLY, IN MY OWN STATE OF NEW YORK, GRANTS OF THIS NATURE ARE SPECIFICALLY FORBIDDEN BY THE STATE CONSTITUTION. IF THIS PROPOSAL WERE TO GO INTO EFFECT, NO I.D.B. WOULD EVER AGAIN BE ISSUED IN NEW YORK STATE.

THE LIMITATION ON ARBITRAGE PROFITS IS EQUALLY UNJUSTIFIABLE. BY INVESTING SOME OF THE PROCEEDS FROM AN I.D.B. DURING A TEMPORARY CONSTRUCTION PERIOD, SMALL FIRMS ARE ABLE TO GENERATE ADDITIONAL CAPITAL, THUS ALLOWING THEM TO BORROW LESS TO BEGIN WITH. BY KEEPING THEIR DEBT-TO-EQUITY RATIO DOWN IN THIS MANNER, THESE FIRMS ARE BETTER ABLE TO OBTAIN CREDIT FROM SUPPLIERS AND BETTER ABLE TO MAINTAIN HIGH LEVELS OF EMPLOYMENT.

BY DENYING A.C.R.S. DEPRECIATION BENEFITS TO ANYTHING FINANCED

USING THE PROCEEDS OF AN I.D.B. IS TO MAKE SMALL BUSINESSES SECOND CLASS CITIZENS IN THE CORPORATE COMMUNITY. I.D.B.s ARE DESIGNED TO GIVE EXTRA ADVANTAGES TO BUSINESSES WHICH STATE OR LOCAL AGENCIES DEEM AS SERVING A PUBLIC PURPOSE. TO THEN PUNISH THESE FIRMS BY DENYING THEM OTHER TAX BENEFITS AVAILABLE TO ALL OF THEIR COMPETITORS IS TO VIOLATE THE PURPOSE OF THE I.D.B. PROGRAM. IN ADDITION, EXCEPT FOR COMPANIES OPERATING AT A LOSS, A.C.R.S WILL ALMOST ALWAYS BE OF GREATER BENEFIT THAN I.D.B. FINANCING. SINCE IT IS NOT THESE LOSS COMPANIES WHICH STATE AND LOCAL OFFICIALS WISH TO ENCOURAGE, THE USE OF I.D.B.s WOULD ALMOST COMPLETELY CEASE FOLLOWING THE ADOPTION OF THIS RESTRICTION.

REQUIRING ALL BONDS TO BE REGISTERED WITH THE S.E.C. IMPOSES UNNECESSARY COSTS AND ADMINISTRATIVE BURDENS ON THE PROGRAM. REQUIRING THAT ELECTED OFFICIALS APPROVE ALL I.D.B.s MAY ALTER THIS PROGRAM FROM PROMOTING ECONOMIC DEVELOPMENT TO AWARDING POLITICAL PATRONAGE.

LIMITING I.D.B.s TO VERY SMALL COMPANIES THROUGH IMPOSITION

OF A CAPITAL EXPENDITURE TEST ELIMINATES THE POSSIBILITY OF A COMPLETE URBAN REVITALIZATION ANCHORED AROUND ONE OR TWO LARGE COMPANIES ATTRACTED TO THE AREA PARTLY THROUGH FAVORABLE FINANCING ARRANGEMENTS. AND PLACING A CAP ON THE AMOUNT OF I.D.B.s A FIRM CAN HAVE OUTSTANDING AT ONE TIME LIMITS THE ABILITY OF SMALL BUSINESSES TO GROW AND EXPAND INTO NEW MARKETS.

THESE PROPOSALS ARE NOT "REFORMS" OF THE I.D.B. PROGRAM. THEY ARE DESIGNED TO KILL IT. THUS, COMPROMISE IS IMPOSSIBLE. EACH AND EVERY ONE OF THESE PROPOSALS MUST BE REJECTED.

REJECTING THESE PROPOSALS, HOWEVER, IS ONLY A FIRST STEP. WE STILL HAVE REVENUE RULING 81-216, ISSUED BY THE I.R.S. LAST AUGUST 24, OUTSTANDING. THIS RULING, AS WE ALL KNOW, HAS COMPLETELY ELIMINATED THE POOLED I.D.B. PROGRAM, WHICH IS EVEN MORE VITAL FOR SMALL BUSINESSES THAN THE "STAND ALONE" I.D.B. PROGRAM. THUS, MY COLLEAGUES ON THIS PANEL AND I INTEND TO INTRODUCE A BILL IN THE NEAR FUTURE WHICH WILL VITIATE RULING 81-216 BY REDEFINING "ISSUE"

IN SUCH A WAY THAT MULTIPLE ISSUES USING A COMMON PLAN OF MARKETING, SOLD AT ESSENTIALLY THE SAME TIME WITH SUBSTANTIALLY THE SAME RATE OF INTEREST AND USING A COMMON SECURITY WILL BE EXPLICITLY AUTHORIZED IN THE INTERNAL REVENUE CODE. THIS LEGISLATION WILL BE RETROACTIVE TO AUGUST 23, 1981, AND WILL RESTORE INDUSTRIAL DEVELOPMENT BONDS TO THE STATUS THEY ENJOYED PRIOR TO ISSUANCE OF 81-216. UNDOUBTABLY, THIS BILL WILL BE REFERRED TO THE FINANCE COMMITTEE. WE HOPE TO HAVE YOUR SUPPORT.

IN CLOSING, I WOULD JUST LIKE TO SAY THAT TAX EXPENDITURES AS SUCCESSFUL AS THE I.D.B. PROGRAM SHOULD NOT BE SACRIFICED ON THE ALTER OF REVENUE ENHANCEMENT. WE CANNOT DO THIS TO OUR STATE AND LOCAL GOVERNMENTS. WE CANNOT DO THIS TO SMALL BUSINESS. WE SHOULD NOT DO THIS TO THE AMERICAN ECONOMY.

AS ONE FINAL POINT I WOULD LIKE TO HAVE INCLUDED IN THE RECORD A MEMO TO MYSELF FROM MS. DEBORAH FEROLITO OF THE NEW YORK CITY INDUSTRIAL DEVELOPMENT AGENCY (I.D.A.) AS AN APPENDIX TO MY STATEMENT. THIS MEMO SPEAKS ELOQUENTLY TO THE NEGATIVE IMPACT RULING 81-216 IS HAVING ON SMALL BUSINESS FINANCING. IN FACT, AS THE MEMO EXPLAINS, INDUSTRIAL CONDOMINIUM FINANCING IS VIRTUALLY IMPOSSIBLE UNDER RULING 81-216.

NEW YORK CITY IDA

NEW YORK CITY INDUSTRIAL DEVELOPMENT AGENCY
225 BROADWAY, ROOM 1200, NEW YORK, N.Y. 10007 (212) 267-9600

WILLIAM S. BRENNEN
CHAIRMAN

MEMORANDUM

March 15, 1982

TO: SENATOR ALFONSE M. D'AMATO

FROM: DEBORAH P. FEROLITO

Traditionally, a major portion of New York City's industrial community has been housed in large multi-tenanted rental structures. A number of historical reasons have contributed to this pattern. The most significant factor, however, is the present situation wherein most New York City industrial firms are quite small while the existing industrial realty is comprised of large multi-storied buildings. Small firms do not need, nor could they afford to own these large buildings.

In recent years, this industrial backbone of the New York City economy has been threatened, and indeed irrevocable harm has been done by the conversion of many of these buildings to residential use. In Manhattan alone, more than half of the existing 4,600 industrial buildings have undergone either partial or total residential conversion. Between 1978 and 1981 the number of manufacturing jobs in Manhattan has decreased by 21,512 from 298,512 to 277,000. The present strong housing demand in

New York City combined with continuing demand for industrial rental space, which is rapidly being depleted, has created an extremely unstable and inflationary situation in the industrial real estate market. In such a market, firms that rent are subject to arbitrary dislocation or exorbitant rent increases at the time of lease expiration. The effect on the New York City industrial sector has been clear. Unable to compete for industrial rental space and unable to afford to acquire a building, many firms have been forced to relocate out of state where land availability and low cost small industrial structures provide an attractive business climate. Alternatively, many companies have chosen to just cease operations and liquidate. New York City has estimated that if the present trend continues, possibly as many as 4,000 firms employing 75,000 people could be dislocated over the next few years as a result of the residential conversion of their facilities.

If these small firms could find the access to capital needed to obtain an equity position in their buildings, they might well be able to stabilize their overhead and circumvent the current chronic instability in the industrial rental market. Despite the fact that industrial development bond financing has been traditionally available for eligible concerns in the financing of separate, but contiguous industrial facilities (such as in an industrial park), conceptual issues combined with legal impediments have stymied these same types of financings for the same or smaller concerns in a vertical manner (such as an industrial condominium).

The strong residential market combined with the large profit margins which can be realized by the residential developer are the fundamental causes of fine industrial buildings being converted to residential use. In a typical residential cooperative conversion, space is divided into 1,500 to 2,500 sq. feet living units. They are marketed as either completed apartments with bathrooms and kitchens, or as "raw" space. Raw lofts are fully enclosed units without kitchens, bathrooms or other rooms. Raw space will conservatively sell in the range of $60,000 to $125,000 per unit plus the pro-rata assumption of the cooperative association's building mortgage. This is usually an additional $30,000 to $50,000 per unit. A typical 12,000 sq. foot industrial floor would be divided into 4 to 5 apartments with a total selling price per floor of between $405,000 to $787,500. In a traditional 12 story building, this would mean the building would be sold for, conservatively speaking, $9,450,000 by the residential developer, at a price of between $33 and $65 per sq. foot of raw residential space. Completed apartments require more initial capital outlay by the developer, but provide proportionally higher returns. Prices can range as high as $150 per sq. foot for a completed apartment unit. If the residential converter elects to retain the building and rent out apartments, the space could easily command $12 per sq. foot.

The potential profit to a residential developer can range from $1,750,000 to $4,000,000. Additionally the strong market demand and enormous profit potential have induced private lending institutions as well as the private individual to choose to invest in these residential projects.

These alternative investment opportunities, combined with the relatively marginal return on an investment in an industrial building, have created a situation wherein conventional financing is practically non-existent for an industrial building acquired with the intention of keeping it industrial. Additionally, the selling price of a building is calculated at its optimum use, i.e., residential conversion. Industrial rent rolls at $3.00 - $4.00 per sq. foot are insufficient to cover operating costs and debt service at this high purchase price. This situation serves as a further disincentive for investors to keep a building industrial.

The City Planning Commission has determined that

> "Residential conversions hurt other neighborhoods in another way. Most of the people working in factories live in New York City. The paychecks they earn in these [factories] are spent primarily in their home neighborhoods. When factories close or move from the City to make way for a [residential] conversion, those paychecks stop and the housing and stores in the workers' neighborhood suffer."

Although the city has adopted stricter zoning laws in an attempt to mitigate the adverse effect of residential conversions, it is acknowledged by the City Planning Commission that 90% of all loft conversions are done illegally without regard to the zoning and building laws of the City.

A viable solution to this problem would be to make industrial development bond financing available to the users of multi-storied industrial buildings, thereby providing the needed incentive to industry to retain and/or create additional jobs in the community with resulting benefits to the City and State in the form of increased tax base and community revitalization.

Ironically, it is the small industrial business who is clearly most in need and deemed to be most eligible for the benefits provided through industrial development bond financing, that is being precluded from using them. The condominium unit represents the smallest piece of realty that can be acquired and used for production. It is most often acquired by the marginally profitable industrial user. However, presently these small industrial users' access to affordable capital is severely limited. Industrial development bond financing can provide the desperately needed source of capital to the firm who could not afford the acquisition otherwise. Furthermore, the availability of industrial development bonds to finance the acquisition of industrial units would greatly enhance their marketability, thereby providing an incentive to owners to keep industrial buildings industrial.

Presently, the only way to acquire an industrial condominium is to participate in the creation of a condominium building. The legal roadblocks occur precisely in that use of industrial development bond financing to assist the small firm in the participation in a new industrial condominium. In fact, if industrial condominiums already existed in sufficient volume to have a secondary market, the financing of a small business's acquisition of a unit would scarcely differ from a typical single-user industrial firm's acquisition of an existing building with industrial development bonds. However, the inability of the small company to employ industrial development bond financing in the initial stages of developing a condominium market, effectively precludes that market from developing.

The New York City Industrial Development Agency conceivably could assist those small companies who could afford to acquire a multi-tenanted building, even though such company might only occupy a minimal percentage of the usable space. However, this would mean the small business would have to now become a landlord and face all the problems of running a building as well as attempting to run its business. Additionally, the potential risk always exists in this situation of the induced company abusing the benefits of access to low-cost financing to reap a windfall profit in what could turn out to be a successful real estate venture. It is the policy of the New York City Industrial Development Agency to require a minimum occupancy of 50% of the financed facility by the induced business in order to be eligible for industrial development bond financing. Further, the Agency requires the company to demonstrate its ability to meet debt service independent of any rental income it may derive from excess footage in the building. These policies virtually ensure that companies will neither incur debt which may be unaffordable nor will they be in a position to abuse a public subsidy for pecuniary gain.

The Agency has attempted to develop alternative financing structures accomplishable under existing law to begin to address the conversion problem. However, each has its own inherent drawbacks as well as uniqueness of circumstance not easily duplicated:

1) An endeavor was made to bring together 3 printing companies to fully occupy a large printing facility on the west side of Manhattan. A joint venture financing was ultimately effectuated wherein these 3 companies formed a common realty holding company. These three companies then jointly acquired a facility (which housed one of the companies) for the operation of their printing businesses. However, the unlikely situation of bringing three unrelated companies together to mutually share in the responsibilities and risks of operating a facility is not easily replicated. This financing is fully cross collateralized and cross guaranteed. Additionally each company is subject to the others' capital expenditures for the next 3 years. The continued success of this financing is dependent upon the mutual

cooperation and fiscal health of three independent competitors in the same industry.

2) Due to the threat of an imminent residential conversion of a major industrial building on Manhattan's west side, the Agency authorized the financing of the acquisition of the building by two developers who fully committed to keep the building as an industrial rental. Due to the fact that the building was so large, no one tenant constituted a principal user (more than 10%) whose capital expenditures would be included in the 10 million dollar limit. Additionally the Agency was able to negotiate certain restrictive covenants in its primary lease with the developers as to their ability to sublease. However, rarely could a financing such as this occur again with all the requisite elements.

3) Finally, an attempt was made to finance the first industrial condominium in New York City with industrial development bonds. After many months of research and deliberation by the Agency's Bond Counsel, a deal was financed. However, under the present law and specifically Revenue Ruling 81-216, the ability to accomplish a condominium financing with industrial development bonds has been severely impaired.

The Agency presently has under consideration at least five separate industrial condominium type projects, the successful financing of which is extremely dependent upon the resolution of the inherent problems created by Revenue Ruling 81-

216. Following a general discussion of the effects of Revenue Ruling 81-216 on industrial condominium financings will be a specific treatment of the practical problems encountered in the first condominium financing.

On August 24, 1981 the Internal Revenue Service issued Revenue Ruling 81-216. The effect of the Ruling has been more far-reaching than could have reasonably been intended by the Service. In no instance can this effect be more clearly discerned than in its prohibitive application toward the financing of industrial condominiums within the City of New York by the New York City Industrial Development Agency.

In brief, Revenue Ruling 81-216 and the regulations proposed pursuant to such Ruling attempt to set forth guidelines in the determination of whether industrial development bond issues having certain common elements should be integrated and thereby treated as one single issue. The consequences of such integration can mean the loss of federal tax exemption of industrial development bond issues having a commonality of certain specified aspects, whether such commonality derives from intentional design or financing necessity. That is, the small issue exemption under the Internal Revenue Code provides for the issuance of tax exempt industrial revenue bonds the face amount of which does not exceed $1,000,000 (or, if the agency files an appropriate election with the Internal Revenue Service, $10,000,000) for financing facilities within a particular municipality for the benefit of a particular entity or entities. An aggregation of separate bond issues each of which by itself would not be in excess of $1,000,000 in face amount (or $10,000,000, as the case may be) but which when taken together would exceed such limitation, is sufficient to cause the loss of federal tax exception. Similarly, an agency may issue tax exempt industrial development bonds in a face amount in excess of $1,000,000 (but not in excess of $10,000,000) provided that the entity or entities for whose benefit such bonds are being issued have not and do not incur, during a six-year period commencing three years prior to the issuance of the bonds and terminating three years after such date of issuance, capital expenditures in excess of $10,000,000 with respect to facilities located in the municipality in which the facility being financed is located. Again, the integrating of bond issues has as a necessary result the combined treatment for capital expenditure purposes of two or more financings and two or more entities, which when treated as a single issue may be sufficient to cause the $10,000,000 capital expenditure limitation to be exceeded and thereby federal tax exemption to be lost.

In determining whether two or more separate bond issues are to be integrated, Revenue Ruling 81-216 provides that the obligations represented by such bond issues are part of the same issue if -

(a) the obligations are sold at substantially the same time,

(b) the obligations are sold pursuant to a common plan of marketing,

(c) the obligations are sold at substantially the same rate of interest, and

(d) a common or pooled security will be used or available to pay debt service for such obligation.

Although the Ruling and proposed regulations indicate that additional facts and circumstances may further evidence whether or nor such obligations are part of the same issue, for ease of discussion only the above four factors will be considered below in the analysis of their application to industrial condominium financing.

As stated at the beginning of this memorandum, an industrial condominium is no different conceptually from a series of industrial facilities vertically situated one upon the other. In a highly developed urban community such as New York City in which industrial space is at a premium and space available for industrial construction is even more scarce, new industrial development must progress vertically or not at all. Yet, as has been most clearly evidenced in a recent financing by the New York City Industrial Development Agency, the practicalities of financing an industrial condominium through tax exempt industrial development bonds will of necessity result in uncertainty as to the application of Revenue Ruling 81-216.

1. "the obligations are sold at substantially the same time,"

A typical industrial condominium financing will involve a group of companies, some or all of whom may be tenants of the building to be acquired and converted to condominium units, entering into a contract of purchase with the owner of such building. The building would then be converted into the several industrial condominium units for the separate companies. Simultaneously with such conversion, the Agency would issue separate bonds to finance the acquisition of the separate units comprising the building. In order to accomplish the financing, the obligations of the Agency must be "sold at substantially the same time". To expect the owner of an industrial building to be willing to sell portions of his building in stages to aid in the creation of an industrial condominium (and thereby bear the risk that the whole of the building may not eventually be sold), when the real estate market in New York City would permit such owner to sell the entire building at once for residential purposes, is an unreasonable expectation. Although the financing could conceivably be effected through a developer's acquiring the building with conventional financing and thereafter utilizing industrial development financing for the sale of the condominium units to the end user, the interposition of a developer will only serve to create an additional layer of profit to be calculated in the costs of the financing for the ultimate users.

2. "the obligations are sold pursuant to a common plan of marketing,"

It is not made clear in either the Ruling or the proposed regulations as to whether the plan of marketing the obligations must be "common" from the perspective of the company-borrowers or from the perspective of the purchaser of the obligations. If viewed from the former perspective, the commonality of marketing plan is inherent in the joint participation of the company-borrowers in each of the building acquisition agreement, the condominium plan and in the simultaneous bond financing. If viewed from the latter perspective, and as is more clearly seen in the discussion of the third factor below, the investment decision to purchase bonds to finance condominium units within the same building may result in the same bank or other lender purchasing all of the bonds for each of the units. Moreover, a factor such as "common plan of marketing" presumes an unlimited financing market to which all potential company-borrowers will have equal access. The experience of the New York City Industrial Development Agency has been that only a limited number of banks have from time to time regularly participated in the Agency's industrial financing program, with Chemical Bank in the past two years being the major participant. The likelihood, therefore, of a bank such as Chemical Bank being the single purchaser of bonds issued by the Agency to finance the acquisition of the several condominium units of a single building, is not reflective of a common design or marketing plan but rather of the limited sources of tax exempt financing generally available to small companies within the City of New York. In addition, part of the investment decision of any lender is the nature of the collateral being financed and the similarity of collateral of each condominium unit of the same building would naturally lead to the same investor reaching a favorable investment-decision.

3. "the obligations are sold at substantially the same rate of interest,"

The determination of the interest rate at which an issue of industrial development bonds will be priced is generally dependent upon two factors -- the creditworthiness of the particular company and the nature of the collateral. As noted above, the nature of the collateral being financed, i.e., the several condominium units comprising the building, would represent a constant in the factoring of the interest rates at which the several bond issues are to be priced. Additionally, different companies seeking to locate their operations within the same physical structure have, by past experience by the Agency, been typically engaged in similar business enterprises and do not differ substantially in their relative credit. The pricing decision, therefore, of interest rates for bonds to finance several condominium units, is likely to result in "substantially the same rate of interest" for such bond issues. Again, the common rate of interest is a reflection of factors of the marketplace rather than of intentional design or plan. Moreover, as further set forth above, the avenues of available financing for most New York City Industrial Development Agency projects has been generally limited to but a few banks with Chemical Bank of recent being the most prominent lender. Chemical Bank as a matter of policy has indicated that in most cases it will price an industrial development bond at 70% of its prime rate with exceptionally good company credits priced at 65% of such prime rate and markedly lesser credits at 75% of prime.

For example, in 1981, the New York City Industrial Development Agency financed a total of 46 projects. Financing for 30% of these projects came from Chemical Bank of which 71% of these financings bore a variable interest rate of 70% of Chemical Bank's prime rate. It would be inappropriate, therefore, to ascribe any significance of commonality to interest rates for bonds issued to finance the several condominium units of a building.

4. "a common or pooled security will be used or available to pay debt service for such obligations,"

As to this final factor, the problem again becomes one of uncertainty in application. Under state law, each condominium unit constitutes a separate definable parcel of real property. A purchaser of bonds to finance a condominium unit will usually require that a mortgage on such unit be granted as security for such bonds. If the purchaser of all of the bonds to finance the several condominium units constituting a single building is a single entity, and if each such bond is secured by a separate mortgage upon the particular condominium unit financed, then in theory the Service might take the position that as to the structural whole of the building, a common mortgage or "common security" exists to secure the payment of debt service for the obligations. Again, uncertainty as to application of factors serves to inhibit the availability of a clean opinion from bond counsel as to the tax exempt status of bonds issued for an industrial condominium financing.

A recent financing by the New York City Industrial Development Agency is instructive as to the uncertainty created by Revenue Ruling 81-216 in the area of industrial condominium financing. Seven unrelated companies, though all tenants in the same building, made application to the Agency to secure financing for the acquisition of their separate floors from the owner of the building as condominium units to thereby assure each company the continued use and expansion of their respective printing operations. After approval by the Agency of the application, the seven companies then proceeded to negotiate a contract of purchase for the building from its owner. Although the request was made, the owner of the building indicated that it would either sell the building in its entirety, or not at all ("the obligations are sold at substantially the same time"). Each company then proceeded independently to seek financing for the purchase of that industrial development bond necessary to acquire its particular condominium unit. Four of the companies already had a long established banking relationship with Chemical Bank and it was only natural that such companies would approach Chemical Bank. The remaining three companies found that their own banks and other lending institutions were not receptive to assisting in the financing and soon also began discussions with Chemical Bank. For these seven companies, Chemical Bank became the only market available to them and Chemical Bank committed to purchase each of the seven bonds ("the obligations are sold pursuant to a common plan of marketing"). In line with its general policy for pricing industrial development bonds, Chemical Bank offered to six of the seven companies an interest rate of 70% of the Bank's prime rate and as to the seventh company, which was a markedly better credit than the other six companies, the Bank offered a fixed interest rate of 12% per year ("the obligations are sold at substantially the same rate of interest"). As a minimum for its security, Chemical Bank obtained a mortgage on each condominium unit as security for the bond issued to finance such unit ("a common or pooled security will be used or available to pay debt service for such obligation").

A literal interpretation of Revenue Ruling 81-216 might lead to the contention that: (1) the above financing constituted but a single bond issue, (2) the facility financed was not seven separate definable parcels of property but one single physical structure, (3) each company's capital expenditure would be attributed to the others, and (4) the aggregate of such capital expenditures would be taken into account in measuring whether such companies as a whole have exceeded the Internal Revenue Code's $10,000,000 capital expenditure limitation discussed above and therefore caused all seven bonds to become taxable. In the above financing, the consequences of taxability were negotiated and would lead to the bonds bearing interest at a conventional, but for these companies highly prohibitive, rate of interest. In the absence of the integration of separate bond issues which Revenue Ruling 81-216 might appear to require, the continued tax-exempt status of each of the seven bonds would be measured by the capital expenditures of the company whose condominium unit was financed with the proceeds of such bond, and not by the aggregate capital expenditures of the entire condominium group. In the interests of caution, the Agency and its counsel advised the companies of the potential consequences of a literal interpretation of Revenue Ruling 81-216 and the companies have agreed to limit their future growth through limiting their collective capital expenditures to within the $10,000,000 ceiling. In the absence of such concern, this potential growth would result in expanded employment and greater economic prosperity for the City of New York.

If the City of New York and other like urban communities suffering from common shortage of available land space are to continue to grow, such growth need be vertical rather than horizontal. It is precisely that small industrial company, for whose benefit industrial revenue bond financing is intended, that is most in need of the availability of industrial condominium units on an affordable basis. Industrial revenue bond financing can and should ideally provide the necessary catalyst to foster the growth of urban industrial condominiums. Revenue Ruling 81-216 inhibits the use of the industrial condominium as an essential tool in urban economic development.

STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM THE STATE OF ALASKA

The **Chairman**. Senator Stevens.

Senator **Stevens**. If Senator Weicker will permit me, I have to leave also to go to another committee meeting.

I want to echo what the Senator from New York has said. We have strong support, I believe, for the Weicker bill in dealing with the industrial development bonds. I am sure you will put all our statements in the record in full.

The **Chairman**. Yes. The statement will be made a part of the record.

Senator **Stevens**. Let me emphasize one thing as far as my State is concerned. We have the Alaskan Industrial Development Bond Authority, and they use the umbrella bond concept for the small businesses in our State that need assistance. Last year, tne AIDA program was successful in creating 21 percent of all the new jobs in our State that were nongovernment. These were created under this industrial development bond approach. The bonds, basically, are aimed toward the new businesses that are expanding and creating new jobs in our State, which is a developing area. We don't really know how these small businesses are going to be able to expand to meet the needs of our State without this kind of assistance. We are very disturbed by the actions of the administration, particularly when this new revenue ruling was issued. We had hoped that the administration would see fit to withdraw it. But, apparently, it is going to take legislation to change it. And we would very much like this committee to assist us and support the Weicker bill, which we all support.

As a matter of fact, I see my good friend from Massachusetts here. And when the two of us agree, it ought to be a formidable alliance, I would say. And we do agree on this. There is a strong bipartisan group in the Senate that wants these IDB's preserved. I hope that this committee will take a long look at this. In particular, I hope the committee will look at the actions of the Treasury in totally eliminating the umbrella concept as a means of financing.

We have a situation in which our State is very much in a development mode. We are looking at over one-half of the coal of the United States. We have probably 30 to 40 percent of all the oil and gas that is going to be discovered in the future of this country; in Alaska or off our shores. We have a fantastic resource base. This type of financing is what is required to assist smaller businesses to phase in with these enormous businesses that come into our State to develop these resources. We do need this extended authority as far as the IDB's are concerned, and I hope that the committee will see fit to support the Weicker approach.

Is that all right if we call it the Weicker approach?

Senator **Weicker**. Fantastic. It's exactly what is needed during one's election year. [Laughter.]

[The prepared statement of Senator Stevens follows:]

INDUSTRIAL REVENUE BONDS

Remarks of Senator Ted Stevens
before the
Committee on Finance

United States Senate
Washington, D.C.

March 17, 1982

Thank you, Mr. Chairman, for the opportunity to appear before the committee today to offer my thoughts on the Treasury Department's proposal concerning Industrial Development Bonds (IDB's).

As you know, the subject of IDB's was one that was forced on Congress by the IRS's action in Revenue Ruling 81-216 in August of last year. That ruling literally gutted the small issue umbrella program - a situation that still exists.

Today, it is not my purpose to offer an alternative to the Treasury's proposal. In the last session of Congress, you, Mr. Chairman, myself, and Senators D'Amato and Weicker attempted to work on some preliminary and very reasonable alternatives to the current state of the law on IDB's. Our efforts culminated in the passage of section 112 of this year's continuing resolution. Our intent in section 112 was to give temporary relief from Revenue Ruling 81-216 until a more permanent solution could be reached.

No sooner had the ink dried from the President's signature on this legislation than Treasury summarily terminated transitional relief from Revenue Ruling 81-216 and pointed the finger at section 112 of the continuing resolution as the culprit.

But now, Mr. Chairman, it has become quite clear why the Department took that position. The current proposal by Treasury clearly spells the end for Industrial Development Bonds.

Let me share with you, Mr. Chairman, why the IDB program should not be modified at the present time, even though a few problems exist with the program.

A current review of the state of our economy conveys how unwise it would be to further exacerbate an already serious economic downturn. The utilization of manufacturing capacity, which ran as high as 90 percent in the mid-1960's, averaged in the low 80 percent range during the 1970's and in the final quarter of 1981 was down to 74.8 percent.

The jobless rate now stands at 8.8 percent - it was as low as 3.3 percent in 1969. Since unemployment data usually lags behind production data, it is anticipated that unemployment will go even higher in the near future.

New housing construction, which peaked at 2,378,000 units started in 1972, is currently running below 1 million starts.

Business failures are climbing sharply. They soared from 24 per 10,000 in 1978 to a rate of 83 per 10,000 now.

Finally, as measured by the Dow Jones average, the stock market has been in a long slide downward. In constant 1981 dollars, the Dow Jones average dropped from an adjusted level of 2.624 in 1965 to less than 800 this year - a decline of 70 percent.

In short, Mr. Chairman, now is not the time to deprive state and local governments of one of the few programs they have available to them to stimulate economic development.

In my home state of Alaska, the small issue IDB program is very important and heavily relied upon to provide financing to a variety of businesses.

The state program is managed by the Alaska Industrial Development Authority, or AIDA, which consists of three cabinet heads; namely, the Commissioner of Commerce and Economic Development; the Commissioner of Revenue, now sitting as Chairman, and the Commissioner of Community and Regional Affairs, as well as two public members appointed by the Governor.

The state has made a very heavy commitment of resources for enhancement of industrial development in the state through the appropriation to AIDA of $166,000,000 in State-held loans in 1980 and subsequent cash contributions of $23,000,000. This state contribution of assets to AIDA reflects the State's determination that industrial development financing is essential to economic development of the state.

This commitment, Mr. Chairman, has paid off handsomely in new jobs created in Alaska. Last year this amounted to 1,753 jobs statewide - or 21 percent of the new non-government jobs created. Incidentally, the 21 percent figure is a very substantial contribution when one considers that currently half the regional employment reporting areas of Alaska are sustaining unemployment in excess of 12 percent.

Let me now turn to the Treasury proposal and why it presents such a large threat - not only to this program, but all IDB programs nationwide.

The centerpiece of the Treasury proposal is that businesses using tax-exempt financing forego the use of the Accelerated Cost Recovery System for depreciation deductions which was enacted at the Administration's request last summer. This proposal would impose an unjustified penalty on businesses using industrial development financing. The penalty is so stiff that by imposing it, Congress would be undoing the financial incentive for economic development which the industrial development bond provisions of the Internal Revenue Code are intended to create in the first place.

This proposal will severely weaken the State of Alaska's economic development efforts. It will impact specifically, and drastically, on AIDA's industrial development financing programs.

AIDA's newest and most widely used program is its Umbrella Bond Program which provided industrial development financing for 216 projects during 1981, the first year of operation of the program, and would provide more loans but for Revenue Ruling 81-216. The average financing is about $350,000.

The projects financed under this program have included numerous types of commercial projects, such as office or merchandising facilities, as well as warehousing and conventional industrial projects. Projects also include North Slope energy facilities, as well as fishing boats. Every one of these projects has meant jobs for Alaskans as I have pointed out.

During the last two years of credit stringency, the emerging Alaska economy has largely depended on the availability of financing from AIDA. This financing has been a vital tool in providing necessary facilities in the energy development of the state and in the modernization of its essential renewable resource fishing industry.

The Treasury's proposed depreciation rules for projects using industrial development financing will dramatically reduce the incentive for the type of enterprising investment that is necessary to get a project off the ground. The Treasury proposal would, if adopted, mean that the number of Alaskan small business projects financed by AIDA, or done in any other way, won't be anything like 200 annually, probably only a handful, with a consequent tremendous loss to the State and to the State's contribution to the national economy.

The Umbrella Bond Program takes its name from the fact that all of the bonds issued in the program share a common security interest in a capital reserve fund created by AIDA from its appropriations. The security interest in the fund helps the bonds sell at a lower interest rate. The Umbrella Bond Program is clearly a vital support to the State's economic development program.

As all of us know, the Internal Revenue Service has terminated this program by issuing Revenue Ruling 81-216. This ruling and the proposed regulations which followed it must be withdrawn by the Administration or legislatively reversed if this worthy program is to continue. Treasury apparently is willing to revoke Revenue Ruling 81-216 if all of its proposals are enacted. This amounts to holding the Umbrella Bond Program hostage for enactment of a tax package that will kill it anyway.

Another of Treasury's proposals would limit the use of industrial development financing under the small issue $10 million limit to businesses that have no more than $20 million of capital expenditures during a six-year test period and have no more than $10 million of industrial development bonds outstanding immediately after the issue. This restriction misses the point that often the form of economic development which a small community needs the most is development by larger businesses. Alaska has scores of tiny communities which would benefit overwhelmingly in employment and economic ripple effect from a project investment by business from the Lower 48 states. This kind of business is extremely likely to have capital expenditures in excess of $20 million. Why should AIDA be prevented from assisting these projects?

The Treasury Department wants to have bond issuers make a financial contribution to the project in an amount equal to at least one percent of the face amount of the issue, or else provide a guarantee or insurance for the bonds. AIDA's Umbrella Bond Program hopefully will meet the requirement of providing a guarantee or insurance for the bonds.

But the financial contribution idea is bad news anyway, because it will eviscerate AIDA's present ability to go outside its Umbrella Program to finance "stand-alone" projects which do not require the capital reserve fund security interest. AIDA has used the stand-alone program to finance a number of larger public airport or dock facilities which are essential to the Alaskan economy given its dependence on transportation. Four of the stand-alone projects have exceeded $10 million, with the largest being $31.5 million.

There is no reason why Congress should require AIDA to make a substantial financial contribution to the project borrowers in these large projects, when the effect of such a contribution is to deplete the amount of assets available to secure small projects in the Umbrella Bond Program through the capital reserve fund.

Finally, Mr. Chairman, many Americans are misinformed about Alaska's current moderate prosperity resulting from oil and gas production. We are now foreseeing a tremendous revenue loss to the State treasury because of the current world excess of crude oil; and even when that situation improves, Alaskans know better than anyone that hydro-carbon resources will last a relatively short time.

That is why economic diversification and building Alaska's industrial infrastructure remain a top priority for this Senator and all Alaskan leaders. AIDA plays a vital role in this process, and IDB's play an important part in the economic development of our country.

Now is not the time, Mr. Chairman, to throw a successful program out. This concludes my remarks, and I would be happy to respond to your questions.

The **Chairman**. Well, there's also strong bipartisan support to balance the budget, and reduce deficits. You wouldn't object, then, if we put the interest income from tax exempt bonds into the minimum tax proposal, would you? That way, everybody would have a chance to contribute to economic recovery.

Senator **Weicker**. Well, I don't think, Mr. Chairman, that you are going to find among the small businesses that you are reaching what you are trying to reach with a minimum tax.

The **Chairman**. We are trying to reach the people that make millions of dollars and don't pay any tax.

Senator **Weicker**. What we are talking about here is basically for small businesses. And these are the ones who are paying the taxes in relationship to the money that they earn.

Senator **Stevens**. I think in terms of that long-range projection of this by the Treasury of an impact over a period of years—if you offset against that, the total concepts of new job creation and the stability as far as the small business sector is concerned, the cost of this is very de minimus, Mr. Chairman. You've got to look at the other side of it. The number of small businesses that continue to fail and the fact that this is the one avenue that gets, particularly under the umbrella approach, these people financing that can continue them in business right now.

The **Chairman**. No. I think there are proper uses. I'm not certain, but I think we are going to have a lot of testimony about how we ought to preserve IDB's for small business. So I would guess by that that nobody would object if we put a $20-million capital expenditure cap that would prevent the Fortune 1,000 corporations from reaping the benefits of IDB use. Certainly, if you are really here to represent small business, you wouldn't object to that kind of a cap.

Senator **Stevens**. Twenty million dollars today is not much in terms of development in the kind of area we are talking about on a resource base. I can show you just one single dragline that is working in the coalfields that is more than $20 million. And that's a very small business, Mr. Chairman.

The **Chairman**. But I think we need to find some reasonable limit.

Senator **Stevens**. I think there could be a reasonable limit, but in terms of the resource development area, and throughout the country, there is the need for capital and it is staggering. And there is just no way you can deal with that on a basis of a $20 million limit. One hundred million dollars might be closer to it. I think that's the small business in terms of expansion capital.

The **Chairman**. Well, we are dealing with the truly needy and the truly greedy around here. And we want to make certain that we find some——

Senator **Stevens**. Well, don't forget that you have an umbrella concept working here. This program is dealing with an umbrella bond over many companies. And if they are going to add the separate issues up, and prohibit on umbrella bond the $20 million limit is certainly not going to do anybody any good.

The **Chairman**. I think the administration's proposal takes care of that problem. Well, they just had a poll in the small business community, NFIB, last fall, which found that 49 percent of the small business respondents opposed the continued use of small issue IDB's, while only 37 percent favored any continued use. The problem is that we talk about small business, but the beneficiaries have been big business. And big business has other sources of credit available. If, in fact, we want to use the taxpayers' funds for big business, then we have to make that judgment. But I think we can, hopefully, work out something.

Senator STEVENS. That's a nationwide thing. Take the poll in the areas where there is a developing economy where people are trying to create small businesses and see what would happen. I don't question it at all if you go through the average town in the United States where small business is almost a static existence. They are going to say we don't need that. But look to the area where there is development potential, and where we have the chance to increase our own production of our own resources, and you would find a tremendous need.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. We will work on it. We'll take it out of the defense budget. [Laughter.]

Senator WEICKER. I'll vote for that. [Laughter.]

STATEMENT OF HON. LOWELL WEICKER, U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator WEICKER. Mr. Chairman, let me say one thing also as far as NFIB is concerned. I speak now as the chairman of the Senate Small Business Committee. I think the NFIB is a great group of conservative philosophers, but I don't think that—at least during the tenure of my chairmanship of that committee—they contributed much to the bread and butter issues of small business.

The CHAIRMAN. I might say that the Fortune 1,000 includes only one-tenth of 1 percent of all U.S. corporations. So as long as we understand we are not trying to benefit big business——

Senator WEICKER. Mr. Chairman, as I said, my principal activity here in the Senate is to chair the committee that is interested in small businesses. And I want to say right now that the present economic game plan, while suiting some, in effect, produces what, hopefully, one day might be a trickle down to small business. And I don't believe in trickle down. I believe in the fact that if we want the best products at the lowest prices in this country, we've got to have the greatest competition. And all I have seen in the last year is a tremendous concentration of economic power and a squeezing out of the small businesses. The key here is not whether a small business can get capital; can small business get affordable capital? Now that's what is putting them on the cross.

Let me just make two additional points. I have submitted my statement in its entirety for the record.

No. 1, in the week ended February 11, you had roughly 525 bankruptcies in this country. That's the highest in 40 years. This year to date, you've had 2,500 bankruptcies compared to 1,300 in 1981. And 1981 wasn't exactly a banner year. Now that's the picture. And the majority of the companies I'm talking about are small businesses. This place sure gets in one big lather when it's a big corporation that goes under. I sat on the floor of the Senate for quite a few months when it was Chrysler that was on the line. That goes on every single day with small businesses in the State of Connecticut and the other 49 States. And nobody raises a finger. And nobody cares. And yet for the consumer and for the overall strength of our free market system, these are the fellows that produce the jobs. Ninety percent of new jobs come out of small businesses. More than 50 percent of all innovation comes out of small business. And yet small businesses are absolutely static at this juncture or going under due to a game plan which clearly is good for the larger aspects of the private sector.

Having said that, the only other point that I am going to make is by way of two examples, which are, I think, the best way I can make my case.

Last spring, when conventional rates were around 16 percent, the Connecticut Development Authority was able to make a loan to New England Machinery for $702,000 for 25 years at 11 percent. New England Machinery is a young growing firm with 35 employees. It manufactures custom packaging machinery. They were able to move from a 10,000-square-foot cramped facility to a vacant 47,000-square-foot former bottling plant. The move has helped the company double its sales, and has provided 25 additional jobs.

The second example, Enson Research in Bridgeport. In June 1980, this closely held manufacturer of aerosol valves and related manufacturing equipment acquired a 70,000-square-foot manufacturing facility in a city-owned industrial park. This park was created when General Electric donated their former manufacturing buildings to the city of Bridgeport. The borrowing rate at closing was 7½ percent at a time when conventional rates would have been closer to 11 percent.

Because of the success of the operation, in October 1981, an additional $2 million of financing enabled the company to install additional production equipment at the site and to renovate its former Bridgeport location, which it had earlier planned to abandon. These two projects have retained 450 jobs in the city of Bridgeport. And the borrowing rate for the second loan was 65 percent of the prime.

Now that is the typical story of the IDB. As Al D'Amato stated, it's not the pornographic bookshop or the disco or the swimming pool or whatever. You know just as well as I do that as long as we have got a program, somebody is going to rip it off. The track record of IDB's is fantastic.

And, Mr. Chairman, I conclude by asking you this. I know you will move on this one way or the other. But please move on it right away because already the pinch is being felt because of what Treasury is doing de facto with this law. And I would hope that we could get it reinstituted and get it going at a time when it is criticallv, critically needed.

[The prepared statement of Senator Weicker follows:]

SENATOR LOWELL WEICKER, JR.
STATEMENT BEFORE
SENATE FINANCE COMMITTEE
ON
INDUSTRIAL DEVELOPMENT BONDS
MARCH 17, 1982

GOOD MORNING, MR. CHAIRMAN. I APPRECIATE THIS OPPORTUNITY TO PRESENT MY VIEWS ON THE ADMINISTRATION'S LATEST PROPOSALS FOR MODIFYING THE USE OF TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS.

LET ME SAY AT THE OUTSET THAT I BELIEVE THESE LATEST TREASURY PROPOSALS ARE UNNECESSARY, UNACCEPTABLE AND COUNTER-PRODUCTIVE. IN MY OPINION, THIS IS A THINLY VEILED ATTEMPT TO ELIMINATE THE SMALL ISSUE IDB PROGRAM UNDER THE GUISE OF REDUCING THE VOLUME OF SMALL ISSUE BONDS AND MAKING THE SMALL ISSUE BOND PROGRAM A SMALL BUSINESS PROGRAM.

WELL, MR. CHAIRMAN, LET'S BE CLEAR ABOUT ONE THING. WHAT THE TREASURY IS PROPOSING HERE IS NOT A SMALL BUSINESS PROGRAM! IF ANYTHING, IT IS ANTI-SMALL BUSINESS.

IT IS ALSO ANTI-ECONOMIC DEVELOPMENT. YESTERDAY, AT A HEARING OF THE APPROPRIATIONS SUBCOMMITTEE ON STATE, JUSTICE AND COMMERCE, OF WHICH I AM CHAIRMAN, I HEARD OF THE ADMINISTRATION'S PLAN TO CUT FUNDING FOR THE ECONOMIC DEVELOPMENT ADMINISTRATION BY 90 PERCENT. COMING ON THE HEELS OF THE TREASURY DEPARTMENT PROPOSALS WE ARE

DISCUSSING TODAY, IT APPEARS THE ADMINISTRATION INTENDS TO LEAVE OUR LOCAL TOWN AND CITIES FLAT, WITHOUT ANY VEHICLE FOR REVITALIZING OUR URBAN AREAS AND PROMOTING JOB CREATION. I BELIEVE THIS IS POOR POLICY AND POOR PLANNING, FOR A NUMBER OF REASONS.

SMALL BUSINESSES RIGHT NOW ARE IN A FIGHT FOR THEIR LIVES. AS CHAIRMAN OF THE COMMITTEE ON SMALL BUSINESS, I CAN TELL YOU THAT SMALL FIRMS ARE GOING UNDER EVERY DAY. BANKRUPTCIES THIS YEAR ARE UP FROM LAST YEAR BY 41 PERCENT, AND OVERALL, BUSINESS FAILURES ARE AT THEIR HIGHEST RATE IN 40 YEARS!

EVEN IN GOOD TIMES, IT IS STANDARD FOR SMALL BUSINESSES TO BE CHARGED HIGHER INTEREST RATES THAN LARGE FIRMS. THESE ARE NOT GOOD TIMES, AND THE STATISTICS TELL THE STORY: WHILE BIG BUSINESS IS BORROWING AT 18 AND 19 PERCENT INTEREST, SMALL FIRMS ARE PAYING 20 TO 21 PERCENT! AT THESE RATES, SMALL BUSINESSES SIMPLY CANNOT AFFORD TO BORROW IN THE COMMERCIAL MARKET.

IN THE PAST, SMALL BUSINESSES IN NEED OF AFFORDABLE, LOW-COST CAPITAL HAVE BEEN ABLE TO TURN TO THE IDB PROGRAM. CONTRARY TO THE PUBLICIZED REPORTS ON THE USE OF TAX EXEMPT FINANCING, THE PRIMARY BENEFACTORS OF THE SMALL ISSUE EXEMPTION HAVE BEEN SMALL BUSINESSES. BY DEFINITION, THE $1 MILLION DOLLAR LIMITATION IMPOSED BY CONGRESS IN 1968 HAS EFFECTIVELY LIMITED THE SIZE OF BUSINESSES WHICH HAVE USED THE BONDS. ACCORDING TO A RECENT REPORT OF THE CONGRESSIONAL BUDGET OFFICE ON THE SMALL ISSUE PROGRAM, OVER 90 PERCENT OF IDB's GO TO CLOSELY HELD, SMALL BUSINESSES.

THE FACT IS, MR. CHAIRMAN, THAT THE SMALL ISSUE, IDB PROGRAM HAS BEEN A SMALL BUSINESS PROGRAM, AS WELL AS AN IMPORTANT TOOL FOR LOCAL ECONOMIC DEVELOPMENT.

IN MY HOME STATE OF CONNECTICUT, IDB's HAVE HELPED MORE THAN 900 COMPANIES AND CREATED OR RETAINED MORE THAN 100,000 JOBS SINCE 1973. LET ME GIVE YOU A FEW EXAMPLES:

LAST SPRING WHEN CONVENTIONAL RATES WERE AROUND 16 PERCENT, THE CONNECTICUT DEVELOPMENT AUTHORITY WAS ABLE TO MAKE A LOAN TO NEW ENGLAND MACHINERY, INC., FOR $702,000 FOR 25 YEARS AT 11 PERCENT. NEW ENGLAND MACHINERY, A YOUNG, GROWING FIRM WITH 35 EMPLOYEES, MANUFACTURES CUSTOM PACKAGING MACHINERY. THEY WERE ABLE TO MOVE FROM A 10,000 SQ. FT. CRAMPED FACILITY TO A VACANT 47,000 SQ. FT. FORMER BOTTLING PLANT. THE MOVE HAS HELPED THE COMPANY DOUBLE ITS SALES, SOME OF WHICH GO OVERSEAS, AND HAS PROVIDED 25 ADDITIONAL JOBS.

LIKEWISE, UNDER THE SELF-SUSTAINING PROGRAM, CONNECTICUT HAS PROVIDED ADDITIONAL JOBS BY AIDING MEDIUM SIZED COMPANIES. ENSON RESEARCH, INC., IN BRIDGEPORT, CONNECTICUT IS A GOOD EXAMPLE.

IN JUNE, 1980, THIS CLOSELY HELD MANUFACTURER OF AEROSOL VALVES AND RELATED MANUFACTURING EQUIPMENT ACQUIRED A 70,000 SQ. FT. MANUFACTURING FACILITY IN A CITY-OWNED INDUSTRIAL PARK. THIS PARK WAS CREATED WHEN GENERAL ELECTRIC DONATED THEIR FORMER MANUFACTURING BUILDINGS TO THE CITY OF BRIDGEPORT. THE BORROWING RATE AT CLOSING

WAS 7-1/2 PERCENT AT A TIME WHEN CONVENTIONAL RATES WOULD HAVE BEEN CLOSER TO 11 PERCENT.

BECAUSE OF THE SUCCESS OF THE OPERATION, IN OCTOBER, 1981, AN ADDITIONAL $2 MILLION OF FINANCING ENABLED THE COMPANY TO INSTALL ADDITIONAL PRODUCTION EQUIPMENT AT THE SITE AND TO RENOVATE ITS FORMER BRIDGEPORT LOCATION, WHICH IT HAD EARLIER PLANNED TO ABANDON. THESE TWO PROJECTS HAVE RETAINED 450 JOBS IN THE CITY OF BRIDGEPORT. THE BORROWING RATE FOR THE SECOND LOAN WAS 65 PERCENT OF PRIME.

SOME WOULD ARGUE THAT THE TREASURY PROPOSAL WILL INCREASE TAX REVENUES. IN MY MIND, THEY COULD NOT BE MORE WRONG. ELIMINATION OF THE IDB PROGRAM WILL SURELY CAUSE LOCAL ECONOMIC DEVELOPMENT TO FALL OFF MORE SHARPLY, REDUCING OVERALL ECONOMIC ACTIVITY, AND ELIMINATING SOURCES OF NEEDED NEW JOBS.

MR. CHAIRMAN, WE DO NOT NEED TO CHANGE THE LAW OR ENCUMBER THE SMALL ISSUE EXEMPTION PROGRAM, AS THE TREASURY DEPARTMENT PROPOSES. INSTEAD, THE CONGRESS MUST ACT TO GET THIS VITAL ECONOMIC DEVELOPMENT PROGRAM INTO HIGH GEAR. TO DO THAT, FIRST, WE SHOULD QUICKLY DISMISS THESE PROPOSALS WHICH CURRENTLY ARE HOVERING LIKE A CLOUD OF UNCERTAINTY OVER THE PROGRAM: AND SECONDLY, WE SHOULD MOVE QUICKLY TO OVERRULE IRS's COUNTER PRODUCTIVE RULING 81-216 WHICH HAS KILLED THE UMBRELLA BOND PROGRAM IN CONNECTICUT AND OTHER STATES.

MY COLLEAGUES AND I PLAN TO INTRODUCE LEGISLATION IN THE COMING WEEKS TO REVOKE THIS DISASTEROUS IRS RULING AND RESTORE THE UMBRELLA BOND PROGRAM TO THE STATES.

OUR TOWNS, OUR CITIES, OUR SMALL BUSINESSES, NEED RELIEF NOW! IF PLANS FOR AN ECONOMIC RECOVERY ARE EVER TO SUCCEED, WE WILL ALL HAVE TO PLAY A PART. THE SMALL ISSUE IDB PROGRAM IS THE BEST TOOL OUR SMALL BUSINESSES AND LOCAL COMMUNITIES HAVE FOR CONTRIBUTING TO THAT ECONOMIC RECOVERY.

I URGE THE MEMBERS OF THIS COMMITTEE TO RESTORE THAT PRODUCTIVE TOOL BY REJECTING THIS ILL-CONSIDERED AND COUNTER-PRODUCTIVE TREASURY PROPOSAL.

THANK YOU.

The CHAIRMAN. I might say in response to your problems with the Treasury—and I don't say it critically—that the chairman of the Ways and Means Committee made a very strong statement on the House floor with reference to umbrella or multiple lot IDB's. It was in response to that statement, I think, that the Treasury action followed. There is strong feeling on the House side that we have to curb some of the growth in IDB's for the same reason we are curbing everything else—we are out of money. But, again, I certainly want to commend the distinguished Senator from Connecticut for his work with the Small Business Committee and his work on the tax bill last year. And for his work on this issue. I hope we can work out some reasonable program that will, in fact, help small business, but not big business.

Senator WEICKER. Fair enough.

The CHAIRMAN. We'll have big business coming in tomorrow saying we shouldn't change leasing.

Senator WEICKER. I think you should.

The CHAIRMAN. If I was getting $100 million plus refunds like GE, I wouldn't want to change leasing either. But we are going to change leasing.

Senator WEICKER. I agree with you, Mr. Chairman. Thanks an awful lot.

Senator BYRD. May I ask you a question?

The CHAIRMAN. Yes. Excuse me, Senator Byrd.

Senator BYRD. Senator Weicker, on page 2, you say by definition the $1 million limitation proposed by Congress has effectively limited the size of businesses and so forth.

Senator WEICKER. That's correct.

Senator BYRD. But on page 4, you say:

> Because of the success of the operation, in October 1981, an additional $2 million of financing enabled the company to install additional equipment.

Senator WEICKER. Well, now, don't forget you are talking about two limitations. There is a $1 million limitation or $10 million insofar as the area is concerned. So there are two different limitations on the amount of money which can be had.

Senator BYRD. Now define the $1 million limitation.

Senator WEICKER. The $10 million is what is permitted within one municipality. So you have the $1 million limitation on the company, but $10 million insofar as the municipality is concerned.

Senator BYRD. But don't you refer on page 4 to a $2 million to a particular company?

Senator WEICKER. Yes. But within a city industrial park, within a municipally owned industrial park.

Senator BYRD. So it's not limited to $1 million?

Senator WEICKER. That's correct. That is correct.

Senator BYRD. It's limited to $10 million. In other words, $10 million could be given to one company?

Senator WEICKER. If you have the company and the city working together, it is possible to go more than $1 million. If it was just the company alone, $1 million would be the limitation.

Senator BYRD. Thank you.

Senator WEICKER. All right.

The CHAIRMAN. One company alone can use $10 million, so long as all capital expenditures of the company in the city were added together. I think maybe in Connecticut small business may be using it. But elsewhere, that is not the case. In the past 5 years, K-Mart used $240 million in tax exempt bonds, the Hospital Corp. of America used $70 million, McDonalds used $43 million, and Weyerhaeuser used $52 million. Now they are not small business. And I don't think we have to keep programs in effect to help people who can find credit anywhere. But IDB's are helpful to the small business type that you mentioned in your statement.

Senator WEICKER. Mr. Chairman, I agree with you. Look, my job is to go ahead and present the case of small business. And, certainly, there has been no better chairman of this committee that has the overview of the economy as you. That is your job. Big and small. So I am here in the capacity of the advocate for small, and whatever can be worked out, the chairman will have my support.

The CHAIRMAN. I appreciate that very much.

Senator WEICKER. Thank you very much. Thank you, Senator Byrd.

The CHAIRMAN. Senator Tsongas.

STATEMENT OF HON. PAUL E. TSONGAS, U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator TSONGAS. Thank you, Mr. Chairman. I would ask that my statement be included in the record.

And the point that I would make today is simply that the fact that there have been abuses does not suggest that you end the program. Indeed, if one were to be judged by that standard, then we all would have resigned last Thursday. [Laughter.]

Let me talk about Massachusetts. We have a very interesting situation in our State. As you know, we have experienced a decline that went over decades, and are now in the process of restoration. A program like IDB's is so important that we undertook a program of targeting because, as you say, there were abuse. And a lot of people saw this as a very convenient way of——

The CHAIRMAN. I don't want to suggest that those programs are necessarily abuses or that abuses are all we should be concerned with. I just suggest the program has been too generous. I don't quarrel with anybody who takes advantage of an existing program. They can do that without abuse.

Senator TSONGAS. I agree. And if we are going to provide that opportunity and somebody takes advantage of it, that's simply human nature.

In Massachusetts, we targeted IDB's. Only 10 percent of the IDB program in our State is commercial, as opposed to as high as 60 percent in States that are not targeted.

This innovative approach has resulted in $140 million in new private investment in our downtowns. We are opposed to using IDB's to build shopping centers that compete with the downtown core and make the downtown core commercially nonviable. It seems to me that there are ways, in addition to what my colleagues have talked about, of tightening up the IDB program so you do not have this competing situation going on. So you do not allow the McDonalds and the K-Marts, and so forth to be in the program.

The second point is the one that you raised. That is that a lot of the money has been siphoned off by major corporations who can find financing elsewhere. I think there are ways of correcting that. Although I would take exception to a particular figure until I could figure out what the impact of that would be on the greatest explosion base we have in the economy, which is high technology. The $20 million figure may not be appropriate for some of those firms who have just gotten themselves going, and which present the enormous potential growth in the economy.

The third point I would make is the issue of revenue loss. I was going to make reference to the figures CBO projected. They project that a total elimination of IDB's would yield only $200 million in 1982. As you know, there are other studies that argue that the lack of economic stimulation would lead to a net revenue loss. We could argue this until the cows come home. But I think the reference you make to GE, was that this program, in essence, is about the same as what we gave to GE via the leasing provisions.

The CHAIRMAN. Do you think we should modify the leasing provisions?

Senator TSONGAS. Only if we wish to have a viable economy, Mr. Chairman. [Laughter.]

The other point I would make—and you have a long list of witnesses, and I will submit for the record—I am not going to be redundant as to the comments made by my colleagues, but in our State we think that we've worked hard in trying to put together an economic development package. IDB's are an integral part of it. Frankly, it is irritating, having done it the way we have done it, to see other States that have not targeted; have not given a damn about how it's implemented. They are now putting us in the situation of having to defend abuses. If you are in the process of curbing those abuses or at least making the violation of the intent less possible, you have our support. We will be with you on that. But let's not throw out the baby with the bath water.

Thank you, Mr. Chairman.

[The prepared statement of Senator Tsongas follows:]

Senator Paul E. Tsongas

Testimony before the
Senate Finance Committee

March 17, 1982

Mr. Chairman, thank you for permitting me to testify on the subject of Industrial Development Bonds. In my view, IDBs have played a crucial role in business and economic development during times of economic uncertainty and record borrowing costs. Now, with a deepening recession brought on by the highest real interest rates in history, the Administration has proposed restrictions which I believe would cripple this important program. I hope that the Committee will give the IDB program the thorough consideration that it deserves before taking any action.

The Massachusetts Program

In Massachusetts, three-fourths of the companies that have received IDBs had sales under $20 million, and one-half had sales under $5 million. These are the companies that depend almost totally on our local banks to finance their expansions. Today, our thrift institutions cannot make long-term loans to these companies, and commercial banks have moved to shorter maturities and to interest rates floating above the incredible prime.

In addition, Massachusetts has a strict program for targeting bonds for commercial real estate projects to the downtowns of our older communities. Only 10% of the Massachusetts IDB program is commercial, as opposed to as high as 60% in states with no commercial targeting. This innovative approach has resulted in $140 million in new, private investment in 92 commercial revitalization projects in the downtowns of our older communities. IDBs, combined in many cases with Urban Development Action Grants, have been proved effective in revitalizing our distressed areas.

Rhetoric Vs. Fact

If this program is to be reformed, I urge that reforms focus on ending the real abuses in the program. The Administration's proposals fail to deal directly with the real abuses. Instead, I believe, they aim primarily to reduce the volume of the IDB program.

One abuse has stood out. That is the use of IDBs for commercial real estate developments that are marginally productive, and often locally unpopular. A major reason for targeting in Massachusetts has been to curb this abuse -- particularly the financing of anchor stores for regional shopping malls which cripple downtown commerce. Basically, if we want to stop the K-Mart and McDonald's syndrome, we should do it. But we should not enact restrictions that choke off the only effective means of cutting interest rates on highly productive investments.

It is essential, when looking at IDBs, to separate rhetoric from fact.

The rhetoric is that IDBs aid large national corporations. In fact, a CBO study found that IDBs have been used overwhelmingly by smaller businesses. Ninety percent of all IDBs issued in recent years went to closely held, unlisted firms which were dependent on local financing. Only 7% went to Fortune 1000 companies, and only one-half of these issues exceeded $1 million.

The rhetoric is that IDBs result in massive revenue loss to the federal government. In fact, CBO projects that total elimination of IDBs would yield only $200 million in 1982. The Administration sees a net federal revenue decrease in 1983 if its proposals are enacted. A recent University of Chicago study questioned the whole assumption of revenue loss. It showed that the private investment stimulated by IDBs actually increases tax revenues.

Although the estimates of revenue gain differ, this is hardly a crackpot notion. Consider the analysis of Dr. Norman Turé, a leading supply side economist, who is now Undersecretary for Tax Policy. In 1980, Dr. Turé wrote the following:

> "IDBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses . . . The resulting expansion of tax bases -- individual, corporate and payroll -- would generate net gains in tax revenues for the federal government and for the state and local governments of the issuing jurisdictions."

The rhetoric is that the eligibility criteria for IDBs are too generous. In fact, the increase in IDB financings in recent years has been caused not by overly generous criteria but by high interest rates. In fact, the "window of eligibility" ($10 million per company per jurisdiction) buys one-fourth less plant and equipment in real terms than the $5 million limit enacted by Congress in 1968. And again, CBO has noted that "the $10 million limit effectively keeps most large corporations from making much use of small issues."

New Investments and New Jobs

In Massachusetts, we have seen the lower interest rates from IDBs stimulate new investments and jobs. The 870 projects financed over the past three years will produce 47,000 new jobs and 18,000 man-years of construction work.

Clearly, not all these are net new jobs. But recent University of Massachusetts studies show that $100 million in new manufacturing investment produces a net reduction in unemployment of over 4,800 jobs and an increase in personal income of $139 million -- in the first year alone. In addition, this investment would produce $11 million in new state tax revenue in the first year, rising to $23 million in the tenth year. These statistics do not even count the added savings in welfare and unemployment benefits.

Do IDBs stimulate new investments? IDB recipients in Massachusetts were surveyed last summer. Eighty-five percent responded that they would have reduced or cancelled plant expansions without the interest rate reductions from IDBs. One-third would have cancelled their expansion outright, another third would have delayed their growth, and one-fifth would have cut back plans by an average 40%.

The Administration Proposal

As a matter of industrial policy, the Administration proposal has two major weaknesses -- which I strongly oppose.

First, the Administration proposes to make business choose between IDBs and accelerated cost recovery. Most IDB users are small businesses without access to affordable capital for long-term expansion. IDBs provide reduced interest rate financing to these firms -- offsetting their disadvantages in the financial markets. Under the Administration proposal, small business would lose that stabilizing financial assistance. In my view, this proposal will result in a chilling of small business expansions at the very time we should be stimulating this type of activity.

Second, the Administration proposes a strict capital expenditure test for all small issue IDBs. In particular, I believe that limiting total IDB and non-IDB investments for companies to $20 million over six years will have a severe negative impact on the high technology industry, which my state and the entire nation depend on for our economic future. The Administration proposes this limitation despite the severe challenge we face from the Japanese in the high technology area. This doesn't make any sense.

Framework for Reform

I urge the Committee to approach IDB reform in terms of the abuses. Restrictions on commercial IDBs would go a long way in the right direction. As I indicated earlier, Massachusetts has limited commercial IDBs to downtown areas. I urge the Committee to consider targeting these projects to "distressed" areas.

Given what is happening in the budget, there will soon be no assistance for distressed areas. Such a policy spells doom for the older urban communities in Massachusetts and throughout the nation. Now the Administration has proposed to use IDBs in connection with enterprise zones -- a concept that may hold limited promise down the road. But I believe that targeting of this type for the IDB program right now could be very helpful.

In conclusion, I can't help but recall the pressurized atmosphere in which Congress put restrictions on IDBs in late 1980. Today, the housing industry is flat on its back and the Administration is talking about returning to mortgage revenue bonds. The lesson for hasty action on IDBs should be clear.

With unemployment growing and small company failures rising at alarming rates, we should be certain that any restrictions are designed to make this program more effective and less subject to abuses. To cripple the program -- with the resulting impact on small business investments, job creation and urban area revitalization -- would damage our economy now and in years to come.

The CHAIRMAN. Senator Byrd.

Senator BYRD. I'd like to make a brief statement at the appropriate time.

The CHAIRMAN. Fine. Senator, I agree with you. I think we can carve out an appropriate use for IDB's. We need to work with you and your staff and other Members who have appeared this morning. There is support, but I think the support is based on a reasonable program, and not one that takes care of everyone. Unfortunately, I find myself chairman of this committee at a time when we are tightening up and not expanding so you can't please everyone who walks in. But there are still a lot of people coming in for more. There are a lot of things that ought to be trimmed back. And this is one that ought to be trimmed back. Maybe that would be unfortunate but when we are taking about $4 away from poor families—I also chair the Food Stamp Committee—I don't know why we have to finance major corporations. So we will work it out somehow.

Senator TSONGAS. Mr. Chairman, let me say that on occasion those of us who are in the minority enjoy the tribulations of those who've become the majority. [Laughter.]

The CHAIRMAN. Well, we will try to weather the storm. [Laughter.]

Senator TSONGAS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Byrd, do you want to make a statement now?

Senator BYRD. Yes, Mr. Chairman. I noted in the newspaper this morning that the chairman commented again on the leasing provisions of the 1981 Tax Act. I want, for the record, to support the chairman's view on that. I think Senator Dole is correct. That we must either modify or repeal and I am inclined to repeal the leasing provision.

My suggestion to the chairman would be if he were willing to have a meeting of the committee at the earliest possible date or maybe even today, and I would present a proposal or the chairman could present a proposal, that the committee go on record as favoring either modification or repeal, without getting into the precise detail. And that the effective date will be either today or February 19, which Senator Dole suggested at an earlier time.

I think this committee has a great responsibility. We approved that provision. We did it with very little debate; very little knowledge of exactly what the ramifications would be. And I don't think any of us foresaw just what the full ramifications were of that proposal. So I think it has got to be repealed or at least drastically modified. And the sooner the public knows that this committee is going to take action on it, I think the better off everyone will be. I think it is alluding and poisoning the entire tax Reform Act or Tax Reduction Act of 1981. And I would hope that this committee would act in a reasonable time. Not necessarily on the detail, but make clear that we do propose to modify or repeal and its effective date will be whatever date the committee is willing to agree on.

The CHAIRMAN. Well, I appreciate the statement from the Senator from Virginia. It seems to me that there is widespread support for either modification or repeal. We are now told that our staff and the Joint Committee have 44 different options on how to modify leasing. And I assume everytime another company pops up, it adds to that number. There are now 44 options, but I think they are all options to sharply modify leasing as of February 19. It seemed to me rather than, in effect, give away taxpayers' dollars—I might say to the Senator from Virginia that the reason I made this statement that it should be effective on the 19th of February is because it occurred to me that by the time legislative action was taken, billions of dollars might have been given up in revenues. We are finding a real problem, right now, in the deficit. And it seems to me that it might be a way to save a billion or two.

I think it is a good suggestion, and I will try to do that as quickly as we can.

Senator BYRD. Thank you.

The CHAIRMAN. We are privileged to have Dr. Rivlin this morning. Alice is the Director of the Congressional Budget Office. Do you have any assistants or are you by yourself? You may proceed, Dr. Rivlin, in any way you wish. Your entire statement will be made a part of the record.

STATEMENT OF DR. ALICE RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. RIVLIN. Thank you, Mr. Chairman. Let me proceed with an abbreviated version of the statement in the interest of saving time. Let me also note that a full report on the small issue bonds which the CBO did last year is available to the committee for further detail.

In the past 10 years, the use of tax-exempt State and local bonds for private purposes has grown sharply and now accounts for about half of all new long-term, tax-exempt issues. Industrial revenue bonds [IRB's] are the primary mechanism for providing tax-exempt financing for private investment in plant and equipment. IRB's may be used without regard to issue size to finance pollution control equipment, airport and port facilities, sports facilities, convention centers, and industrial parks.

Small issue IRB's, which may not exceed $10 million, may be used to finance plant and equipment for other unspecified private business purposes. Small issues, which are used to finance a wide variety of facilities from manufacturing plants to country clubs, now account for about one-fifth of all new issues of long-term tax-exempt bonds. Estimated sales in 1981 were $10.5 billion, an increase of 25 percent over the 1980 level.

Small issues are particularly advantageous to large geographically dispersed corporations since the dollar limit on issue size and capital expenditures applies not to the firm, but to facilities within an incorporated county or municipality. Large retail chains are probably in the best position to use IRB's because single stores usually can be financed for less than $10 million. As the chairman noted earlier, in the past 5 years the largest single user of small issue IRB's was K–Mart, which financed about 100 stores with $240 million in tax-exempt bonds.

The growth in revenue bond sales has not been limited to small issues. Sales of pollution control bonds increased by 56 percent in 1981 when they reached $3.9 billion, up from $2.9 billion in 1980. Tax-exempt hospital bonds increased by 42 percent from $3.6 billion in 1980 to $5.1 billion in 1981.

One issue the committee should consider is whether subsidies for private-purpose financing are still necessary in the light of both the business tax cuts enacted under the Economic Recovery Tax Act of 1981 and other changing conditions. It is questionable, for example, whether tax-exempt bonds are still necessary to subsidize hospital construction in view of the current national surplus of hospital beds. A second issue is whether the municipal bond market can continue to absorb large increases in private purpose financing. A third is whether tax-exempt bonds are the most efficient means of providing subsidies if any are necessary. In the case of pollution control bonds, for example, tax-exempt financing is available only for end-of-the-pipe capital expenditures, which discourages selection of other possibly more effective solutions to the underlying pollution problem, such as the use of less polluting raw materials for production processes.

The administration has taken the position that the accelerated cost recovery system [ACRS] included in last year's tax legislation has made other subsidies, such as tax-exempt financing, obsolete. Accordingly, it proposes to prohibit firms from using both IRB's and ACRS. Unless the Congress has a special reason for providing industry with subsidies so deep that they result in a negative tax rate, the idea of trading accelerated depreciation for tax-exempt financing would appear to merit consideration.

The administration has also proposed that small issue IRB's not be allowed for businesses with capital expenditures nationwide of more than $20 million over a 6-year period. This would, in most cases, make it impossible for the Fortune listed firms to use small issues. The net effect of the administration's proposal would be to target the use of IRB's generally, and small issues in particular, to smaller firms.

The resulting cutbacks in the use of tax-exempt bonds for private purposes would tend to reduce municipal bond interest rates, which have recently reached record highs. The cost of financing public projects, such as streets, sewers and schools, would then be lower. If the Congress determines that subsidies for private purposes in some areas are still necessary, it might want to consider direct subsidies, which are more efficient and have no adverse effect on the municipal bond market.

Tax-exempt financing for private purposes has been an issue for several years. Present law warrants reexamination to determine whether the subsidies currently being provided serve a public purpose and continue to be necessary in view of recent developments and changes in tax legislation.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Rivlin follows:]

STATEMENT OF

ALICE M. RIVLIN
Director

CONGRESSIONAL BUDGET OFFICE

Before the
Committee on Finance
United States Senate

March 17, 1982

There should be no release of this document before its delivery, scheduled for 9:15 a.m. (EST) March 17, 1982

Mr. Chairman, my testimony this morning deals with two matters:

- Recent trends in the use of tax-exempt bonds for private purposes, and;
- The likely effect of the Administration's proposals to curb the growth of revenue bond financing.

RECENT TRENDS IN THE USE OF TAX-EXEMPT BONDS FOR PRIVATE PURPOSES

In the past ten years, the use of tax-exempt state and local bonds for purposes other than schools, roads, sewers, and other public projects has grown sharply. Private-purpose financing now accounts for about half of all newly issued, tax-exempt long-term bonds.

Industrial revenue bonds (IRBs) are the primary mechanism for providing tax-exempt financing for private investment in plant and equipment. Since state and local governments issue these bonds, their interest income is exempt from federal taxation, making it possible for businesses to benefit from below-market interest rates. With IRBs, a government issuer transfers its tax-exempt status to a private borrower, and the federal government gives up revenues to subsidize the borrowing costs of private industry. Generally, the only backing for the bonds is the credit of the borrowing firm or the revenue from the facility financed. If the borrower defaults, the bondholder bears the loss, so that, regardless of how many IRBs a state or local government issues, its credit rating is unaffected. Consequently, the normal motivation to limit the number of bond issues is lacking.

IRBs may be used to finance a wide variety of facilities without regard to issue size. These include pollution control equipment, airport and port facilities, sports facilities, convention or trade show facilities, and land for industrial parks. IRBs may also be used to finance plant and equipment for other unspecified private business purposes, but these issues may not exceed $10 million. Moreover, if the issue exceeds $1 million, total capital expenditures on all of the borrowing firm's facilities within the same county or city may not exceed $10 million for the three years before and the three years after the issuance of the bond. These so-called "small issues," which are used to finance a wide variety of facilities from manufacturing plants, to doctors' offices, to country clubs, account for the largest share of all tax-exempt bonds floated for private purposes. The other major uses of tax-exempt bonds are for pollution control and solid waste disposal equipment, private hospitals, and port and airport facilities. (So far, the use of the bonds for industrial parks, sports facilities, and convention centers has been limited.) I will briefly outline for you the growth in the use of tax-exempt financing in each of these areas, starting with small issues, which were the subject of a Congressional Budget Office (CBO) report published in 1981.

Small Issues

As of 1970, most states used small issue IRBs only for manufacturing and closely related facilities. By the mid-1970s, however, state and local officials, brokers, bankers, and businessmen realized that federal law made virtually any enterprise eligible for small issue IRB financing. One state legislature after another began to pass laws relaxing or entirely removing the restrictions that earlier had confined the use of the bonds. Today, 48 states use small issues, and more than half of these states put no restrictions on the use of the proceeds.

Small issues are particularly advantageous to large, geographically dispersed corporations, since the dollar limit on issue size applies not to the firm, but to facilities within an incorporated county or municipality. Large retail chains are probably in the best position to use IRBs because single stores usually can be financed well within the $10 million capital expenditure limit. Based on listings in Moody's Bond Record, the largest single user of small issue IRBs in the past five years was K-Mart, which financed some 100 stores with $240 million in tax-exempt bonds. Other large users during the same period were Hospital Corporation of America ($70 million), Kroger ($55 million), Weyerhauser Corporation ($52 million), and McDonald's Hamburgers ($43 million).

Between 1975 and 1980, small issue sales increased from $1.3 billion to $8.4 billion. Preliminary indications are that in 1981 small issue sales increased by 25 percent to $10.5 billion and represented nearly 19 percent of all new long-term tax-exempt bond issues. Most small issues are private placements with banks or other lenders and are rarely reported beyond the state or local level. Consequently, the volume of issues is impossible to determine precisely. (In an effort to estimate small issue sales, CBO requested data from all of the states that permit use of the bonds and from certain local agencies. Most states had good records, but some had incomplete information or none at all.)

Pollution Control Bonds

Sales of tax-exempt pollution control bonds registered a hefty 56 percent increase in 1981, when they reached $3.9 billion, up from $2.5 billion in 1980, and accounted for approximately 7 percent of all new long-term tax-exempt bond issues. Pollution control bonds finance approximately 40 percent of all private investment in pollution control equipment. The exemption for pollution control equipment antedated the passage of federal environmental control laws, and may initially have served as an incentive to induce firms to undertake pollution abatement measures voluntarily. Today, the availability of tax-exempt bonds--or any other subsidy for pollution control--can have only limited influence on a company's decision to invest in pollution control equipment. Federal pollution control regulations are highly prescriptive, so that firms must sooner or later make required improvements. In some cases, however, the choice may come down to renovating an older plant or transferring some operations to a newer one elsewhere.

Private Hospital Bonds

The volume of tax-exempt bonds used to finance hospital construction increased nearly 42 percent from $3.6 billion in 1980 to $5.1 billion in 1981 and accounted for approximately 9 percent of all new long-term tax-exempt financing last year. Tax-exempt bonds finance about half of all new hospital construction, and approximately three-fourths of all bonds issued are for privately owned facilities. The use of tax-exempt bonds to finance hospital and medical equipment has grown especially rapidly in the last few years. For hospital equipment, the trend is toward short-term tax-exempt financing. The necessity of providing subsidies for new hospital construction has come into question because at present the United States has a surplus of hospital beds. Consequently, direct federal subsidies for hospital construction have been cut back sharply in recent years. Despite a national surplus, some areas might lack adquate hospital facilities, making selective use of some form of subsidy worthy of consideration.

Port and Airport Facilities

The use of tax-exempt bonds to finance port and airport facilities for private industry has shown no clear trend in recent years. Single projects--such as an oil pipeline, or an offshore oilport or an airline terminal--may amount to hundreds of millions of dollars and account for the bulk of reported expenditures in any given year. At present, ports on both the East and the West coasts are developing plans to expand their coal exporting capacity. Indications are that over the next five years several billion dollars worth of IRBs will be issued to finance port dredging and terminal construction. Although these types of projects usually attract much attention, smaller port and airport projects are often unreported. Consequently, the precise volume of issues for port and airport facilities is unknown, and an agency-by-agency survey of port and airport authorities would be necessary to determine it.

ADMINISTRATION PROPOSALS

The Administration has recently submitted proposals to curb the use of tax-exempt bonds. These proposals raise a number of issues: First, are subsidies for private-purpose financing necessary, particularly in light of the generous business tax cuts enacted under the Economic Recovery Tax Act of 1981? Second, can the municipal bond market continue to absorb large increases in private-purpose financing? Third, are tax-exempt bonds the most efficient means of providing subsidies, if any are necessary.

The Need for Subsidy

The Administration has taken the position that the accelerated cost recovery system (ACRS) included in last year's tax legislation has made other subsidies, such as tax-exempt financing, obsolete. Accordingly, the Administration proposes that assets financed with tax-exempt bonds issued after 1982 be depreciated using the straight-line method over an extended recovery period, which is roughly twice as long as the period permitted under ACRS. In addition, the Administration proposes to limit tax-exemption to bonds that are publicly approved by local governments and that, after 1985, receive a financial contribution or commitment from the local government. Small issue IRBs would not be allowed for businesses with capital expenditures nationwide of more than $20 million over a six-year period.

The Administration's proposals could result in significant cutbacks in the use of tax-exempt bonds for private purposes, although much will depend on interest rate levels and on the ratio of tax-exempt to taxable yields. Under current market conditions, firms in the 46 percent tax bracket, which account for most IRB users, would be virtually indifferent between accelerated depreciation and tax-exempt bonds. If interest rates were to remain high and the ratio of taxable to tax-exempt yields were to decline, IRBs would be more attractive. In any event, unless the Congress has a special reason for providing industry with subsidies so deep that they result in a negative tax rate, the idea of trading accelerated depreciation for tax-exempt financing would appear to be equitable. At current interest rates, the combination of IRB financing and accelerated depreciation for a typical equipment purchase would result in greater tax savings than would occur if the investment was immediately recovered in full (or "expensed"). This could cause distortions in capital resource allocation. Regardless of whether firms choose ACRS or IRBs, cost savings would result, ranging from about $300 million in fiscal year 1984 to $3 billion in fiscal year 1987.

The Administration's proposals would also remove the advantage that large, geographically dispersed firms have in using small issue IRBs. A nationwide capital expenditure limit of $20 million will in most cases make it impossible for Fortune-listed firms to use small issues. Firms with annual sales of less than about $125 million would be much less affected by the limit. CBO estimates that this provision alone would cut back small issue IRB use by between 15 and 20 percent. The net effect of the Administration's proposals would be to target the use of IRBs generally--and small issues, in particular--to smaller firms.

The Effect on the Municipal Bond Market

At present, municipal bond interest rates and the ratio of tax-exempt to taxable yields are at record highs. Historically, the ratio has been 0.7. It is now between 0.85 and 0.9. In other words, tax-exempt rates, which tended to be approximately 30 percent lower than conventional rates, are now only between 10 and 15 percent lower. As a result, the savings normally associated with tax-exempt financing are eroding, making the financing of public projects relatively more expensive. The growth in private-purpose financing is partially, but not entirely, responsible for these developments. In the past year, banks and casualty insurance companies have either had lower profits or found other means of shielding income from taxation, with the result that they have substantially cut back on their purchases of tax-exempt bonds. At the same time, the cut in the maximum tax from 70 to 50 percent and the expansion of other tax-favored investment options in the 1981 Tax Act have lessened individual demand for tax-exempt bonds. Despite these structural changes, cutbacks in the volume of tax-exempt bonds for private purposes can only lessen the cost of financing public projects.

The Efficiency of Tax-Exempt Bonds

If subsidies for private industry are necessary, it is questionable whether tax-exempt bonds are the best way to provide them. Direct subsidies may be a less expensive and more efficient alternative, since the entire subsidy would then go to the industry or institution. With tax-exempt bond financing, between a quarter and a third of the subsidy goes to bondholders, underwriters, and bond counsel. Tax-exempt bonds often result in other inefficiencies. In the case of pollution control bonds, for example, tax-exempt financing is available only for "end-of-pipe" capital expenditures, which discourages selection of other, possibly more effective, solutions, to the underlying pollution problem--such as the use of less polluting raw materials or production processes. Direct subsidies would encourage more efficient use of resources. In the case of hospitals, targeting direct subsidies to areas that may have shortages of adequate facilities may be a much less costly and more efficient means of providing assistance than the continued universal availability of tax-exempt financing.

Other Approaches

An alternative that the Congress may wish to consider would be to target the use of tax-exempt financing to needy or distressed areas. The major problem with such an approach is the difficulty of arriving at definitions of distress that represent a consensus without including most of the country.

The Congress may, of course, decide to maintain current law. If so, it may at least want to consider instituting a reporting requirement for all tax-exempt bond sales in order to make possible more accurate estimates of the cost of continuing tax-exemption. If so, the Congress could make tax-exemption conditional on the reporting of sales to a designated federal agency. H.R. 4717, as passed by the Senate, would institute a reporting requirement for small issues. The bill is now awaiting conference.

CONCLUSION

Tax-exempt financing for private purposes has been an issue for several years. Current law--which essentially goes back to 1968--warrants reexamination to determine whether the subsidies the federal government is providing to private industry continue to serve a public purpose and whether they continue to be necessary in view of more recent developments and changes in tax legislation. The Treasury has tried to address these issues in its proposals. Other proposals may be equally valid. Clearly, however, the problem needs to be addressed.

The **Chairman**. Senator Byrd.

Senator **Byrd**. Dr. Rivlin, in the earlier part of your statement—I didn't want to interrupt you at the time—it was not clear. You mentioned that one-fifth of the tax-exempt industrial development bonds were used for a certain purpose. I didn't get that.

Dr. **Rivlin**. Those are the small issues.

Senator **Byrd**. Beg your pardon.

Dr. **Rivlin**. The small issues account for about one-fifth. The others are for pollution control, hospitals and other purposes.

Senator **Byrd**. Thank you. That clarifies that point. Is it your feeling that Congress should tighten up considerably on the use of these industrial development bonds?

Dr. **Rivlin**. We think grave questions are raised by the actual uses of them, and that Congress should certainly reconsider whether the purposes for which you intended this provision are really being served.

Senator **Byrd**. Would you change the limitations? The dollar limitations?

Dr. **Rivlin**. The administration's proposal to set a nationwide dollar limitation, rather than just county by county or municipality by municipality, would serve to cut out the big national firms that are using this device to finance facilities in different parts of the country, this would seem to me certainly to merit serious consideration.

Senator **Byrd**. Yes. It seems to me it would. I have felt that while the industrial revenue bonds do serve a purpose and have a place that they have been—I don't want to use the word "abuse," because that's the law. The law is that persons can take advantage of this provision. But I think it should be greatly tightened up. As to exactly how to tighten it up is something else. I think that provision you mentioned there makes a lot of sense. In any case, I think the time has come to tighten up on the use of and the purposes for which these bonds are used. Thank you.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman.

Ms. Rivlin, I would like to know your assessment of the wisdom of cutting back on IDB's at a time when interest rates are excessively high. Do you feel that the IDB advantage actually produces some building that would not be there in a time of high interest rates?

Dr. **Rivlin**. I think it's a difficult question. Obviously, interest rates are high for everybody at the moment. They are high for State and local governments wanting to finance projects for municipal purposes too. The elimination of IDB's or the restriction of IDB's would certainly make interest rates higher for the private borrower who is taking advantage of them, and lower for the public borrower.

Senator **Bradley**. Well, do you think that the municipal bond market can assume larger financing for such private purpose issues as IDB's?

Dr. **Rivlin**. I think it's doubtful. It's a very large part of the tax-exempt market—now roughly half. And it certainly contributed to raising municipal bond rates.

Senator BRADLEY. So your thought is that half of the tax-exempt financings now goes to IDB's.

Dr. RIVLIN. Roughly of the long-term, tax-exempt financing.

Senator BRADLEY. And that they are crowding out the potential access to revenues for local governments and raising the interest rates for local government issues?

Dr. RIVLIN. Yes. I think they certainly contribute heavily to the record high rate on municipal bonds.

Senator BRADLEY. In light of the provisions in the Economic Recovery Tax Act you mentioned, I think, on page 5 of your testimony, do you think that there is less or more reason for IDB's this year than last?

Dr. RIVLIN. Oh, clearly, less. To the extent that IDB's were a way of encouraging general business investment, you have already done that in the 1981 tax legislation. I think the administration's idea that firms putting up private facilities ought not to benefit from both IDB's and ACR's is logical.

Senator BRADLEY. Does it make any sense to you to set a certain targeting criteria for the use of IDB's? For example, in many areas of my State you find IDB's being used for private investment in areas which might not have received investment. Does the targeting concept appeal to you at all?

Dr. RIVLIN. Yes. If the intent of the Congress is to encourage investment in particular areas that are having difficulties, that's one way to do it. Targeting would also reduce both the revenue loss and the upward pressure on municipal bond rates.

Senator BRADLEY. Do you have any thoughts as to how that might be targeted?

Dr. RIVLIN. Targeting is always difficult, as you know.

Senator BRADLEY. That's why I wanted to get the CBO's opinion.

Dr. RIVLIN. Depending on the intent, disadvantaged areas could be targeted in some way. One could put together a set of census statistics that would direct the financing to those areas. It is not easy to do, however.

Senator BRADLEY. And your assessment of the rationale for the administration's proposal to limit IDB small issues to companies of under $20 million is that the bigger companies can take care of themselves? Is that the idea?

Dr. RIVLIN. Yes. There is a question about whether any particular national interest is served by current law.

Senator BRADLEY. If you had a targeting criteria, and a large company wanted to invest in the targeted area, what, in your opinion, should be more important? The investment in the targeted area or the fact that it's a larger company taking advantage?

Dr. RIVLIN. I think that's a question for the Congress and not for me. What do you want to accomplish with this provision? If your primary purpose is to get some kind of investment into targeted areas, then the target should dominate. If the primary purpose is to help small business generally, which some of the Senators on the previous panel suggested, then I think the dollar limit on national firms makes more sense.

Senator BRADLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Rivlin, first I want to thank CBO for their study in April, which was updated in September. It was very helpful to our committee staff. And we thought it was an excellent study. I believe that we can work out some sound legislation. But I don't believe that we should be concerned about Allied Chemical or Dow Chemical or Burlington Industries or Colt Industries or Corning Glass Works or General Mills or General Motors. Those aren't exactly mom and pop operations.

Dr. RIVLIN. No; they are not.

The CHAIRMAN. A lot of moms and pops work there. [Laughter.]

And those are the areas that need our attention. Hospital Corp. of America, for instance, as you have indicated—we are trying out ways to use the extra beds that we have now, the excess beds. The cost of medicare is about to go through the ceiling. It's up to $56 billion this year, headed for $100 billion by 1990. Ten years ago it was estimated it would be $9 billion by 1990. So K-Mart, over the last 10 years, has used $334 million in bonds. And McDonalds—not in that area, but substantial. So I would guess—and you have responded to some of the questions that I have had—it is my understanding at least that this does have an adverse effect on traditional municipal bonds. Is that your conclusion?

Dr. RIVLIN. Yes; it's hard to say exactly how much, but it certainly puts upward pressure on their interest rates.

The CHAIRMAN. I think the administration bill deserves consideration. So I would hope that we may be calling on you for statistical data and information of that kind. We have to make a final judgment, I understand. We appreciate very much your being here this morning.

Dr. RIVLIN. We are available to help further if necessary.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Let me ask one question if I may. You mentioned the record high interest rates which communities now must pay for municipal bonds.

Dr. RIVLIN. Yes.

Senator BYRD. On municipal bonds. What does the average city or average county now pay in the way of interest on municipal bonds, tax-exempt municipal bonds?

Dr. RIVLIN. Let me see if one of my staff has a recent quotation on that.

This is Mrs. Richardson who was responsible for our report last year.

Mrs. RICHARDSON. It depends a lot on the credit rating of the city. In some cases, cities have been paying long-term, tax-exempt rates in the neighborhood of 9 to 10 percent; others have been paying more.

Senator BYRD. What?

Mrs. RICHARDSON. Nine to ten percent, or more. I can check more recent figures, and if there is any change in this, I will make the change for the record.

Senator BYRD. Would that be what you might call an average?

Mrs. RICHARDSON. Let me get you an updated figure for the record. I haven't checked the most recent bond buyer index, which would give you the average.

Senator BYRD. Very good if you would. And could you have that information telephoned to my office?

Mrs. RICHARDSON. Sure. I'll do that this afternoon.

Senator **Byrd**. Thank you.
[The information follows:]

U.S. Congress,
Congressional Budget Office,
Washington, D.C., March 17, 1982.

Hon. Harry F. Byrd, Jr.,
Committee on Finance,
U.S. Senate, Washington, D.C.

Dear Senator: In response to your questions on tax-exempt interest rates at the Senate Finance Committee hearings this morning, I would like to pass along the following information.

In the past two years, municipal bond interest rates have risen steadily and sharply. Although the rate that a municipality will pay on any single issue will depend heavily on its credit rating, the size of the issue and the timing of its entry into the market, the Bond Buyer index provides a good indication of general trends. This index, which is compiled weekly, is based on 20 representative general obligation bonds with varying ratings and 20-year maturities. (The Bond Buyer is a daily publication that covers developments in the municipal bond market.)

As the following table indicates, municipal bond rates declined from 1975 to 1977, increased slightly in 1978, remained fairly stable in 1979, and have since been rising sharply. (The table shows the highest and lowest average interest rates recorded for each year since 1975. The percentage difference between the high and low yields is an indication of the volatility of municipal bond rates, which also has been greater since 1980.)

MUNICIPAL BOND RATES, 1975–81

[In percents]

Year	High yield	Low yield	Percentage difference
1975	7.67	6.27	22.3
1976	7.13	5.83	22.3
1977	5.93	5.45	8.8
1978	6.67	5.58	19.5
1979	7.38	6.08	21.4
1980	10.56	7.11	48.5
1981	13.30	9.49	40.1

As of March 11, 1982, the index for general obligation bonds was 12.71 percent. The *Bond Buyer* index for tax-exempt revenue bonds was 13.59 percent. Revenue bond interest rates are generally higher because general obligation bonds are backed by the full faith and credit of the issuing locality; revenue bonds are backed by the revenues from the facility or project being financed, rather than by general tax funds.

If you have any further questions, please let us know.

Sincerely,

Alice M. Rivlin, *Director.*

The **Chairman**. Senator Grassley.

Senator **Grassley**. I have no questions.

The **Chairman**. Thank you very much.

I think there will be other witnesses, Senator Byrd, from different cities that might have information, too.

Dr. **Rivlin**. Thank you, Mr. Chairman.

The **Chairman**. Our next witness, in fact, we have a panel of witnesses consisting of Jeffrey Esser, director of Federal liaison center, Municipal Finance Officers' Association; Richard Guthman, Jr., council member, city of Atlanta, Ga.; Peter Shapiro, county executive, Essex County, N.J.

I remind the witnesses that your entire statements will be made a part of the record. It's my hope that you can summarize your statements and not each repeat what the other one has said because we have three or four panels of witnesses remaining, and we would like to finish them all this morning.

Do you have an order in which you wish to proceed?

Mr. **Guthman**. Mr. Chairman, I will go first.

The CHAIRMAN. OK. Mr. Guthman will be first. Mr. Shapiro, are you second?

Senator BRADLEY. Mr. Chairman, let me just welcome Mr. Shapiro to the committee. He's one of the outstanding public servants in New Jersey. He runs an outstanding county operation, and I am sure his comments here today are going to be very helpful to the committee. And we welcome you, Pete.

Mr. SHAPIRO. Thank you, Senator.

The CHAIRMAN. Dick, go ahead.

STATEMENT OF RICHARD GUTHMAN, JR., COUNCIL MEMBER, CITY OF ATLANTA, GA.

Mr. GUTHMAN. Mr. Chairman and members of the committee, I am Richard Guthman, council member in Atlanta, and chairman of the National League of Cities' Finance, Administration, and Intergovernmental Relations Policy Committee. I appreciate your giving me this opportunity on behalf of NLC to present the views of city officials on industrial development bond and minimum tax proposals before the committee.

My primary purpose here today is to urge the committee to pass legislation that will control the issuance of tax-exempt industrial development bonds. NLC is no newcomer to this position. We have held this view for several years. Our concern about IDB's transcends the often publicized abuses of small issue IDB's to the fundamental need to preserve the municipal bond market for clearly public needs. As much as we might like to, we simply cannot go on lending tax-exempt credit to an ever-expanding list of private purposes.

Moreover, IDB's have lost their effectiveness as an economic development tool for cities because they are nearly universally available, practically for the asking.

While our position is not new, there has never been a greater urgency to act than now. The municipal bond market is ailing. Interest rates are through the roof, but that is not news to you since all of the markets are suffering.

What is particularly disturbing, though, is the fact that the spread between tax-exempt and taxable rates has narrowed substantially. Traditionally, the spread between long-term, tax-exempt, and taxable rates has been about 30 to 35 percent. In 1981, that margin shrank from 10 to 15 percent. The difference is still dangerously small.

What these shrinking spreads tell us is that the demand for tax-exempt bonds has fallen relative to other investments. One reason for this is that institutional investors have left the market in droves. Market analysts tell us, furthermore, that commercial banks, historically our best customers, may not return to the market to the same degree that they have participated in the past, even after economic recovery. Fortunately for us, last year, individual buyers, attracted by very high interest rates, replaced some of the demand in the market or else it would have collapsed. We cannot continue to rely on individuals to prop up this market. That is, if we want affordable interest rates.

One reason for that is that the Economic Recovery Tax Act of 1981 not only lessened the the need for tax shelter, it also made tax shelter more readily available. The changes in tax laws further reduce the demand for bonds.

The market functions according to laws of supply and demand. Interest rates on bonds have increased as demand has decreased. The prices on bonds have gone down as supply has increased. There is little cities or States can do to adjust the demand, but we can address the matter of supply. We need to, in effect, set priorities on the use of limited tax-exempt credit. And in doing so, we must conclude that public needs, such as the building of roads, bridges, sewers, water lines, public buildings, airports, and ports, deserve a preference over essentially private purposes.

As it is now, bonds for private purposes are gradually crowding out regular State and local government general obligation and revenue bonds from the market. As recently as 1976, regular GO and revenue bonds accounted for three-fourths of the volume. Now they are only half the total long-term tax-exempt volume. Particularly noticeable has been the growth of small issue IDB's which have exploded from $1.4 billion in 1976 to an estimated $10.5 billion last year. In that time period, they have gone from 4 percent of the market to approximately 19½ percent.

Pollution control bonds and bonds for utilities also represent growing sectors of the market.

Someone put it quite aptly not long ago when he said that the major question for this decade in public finance is who will get the tax-exempt money—the local hamburger chain or the local highway system?

NLC endorses the administration's proposal to control IDB's with some exceptions that I have detailed in my formal statement submitted for the record. We think it is quite ingenious. It forces potential private beneficiaries of bonds to choose the tax break they want, instead of receiving a tax break in the form of accelerated depreciation—that is ACRS enacted last year—in addition to tax-exempt financing. Moreover, the proposal does not eliminate any current statutorily authorized uses of bonds.

We are not so naive to think that this proposal is not without considerable controversy. There are those who do not want any changes whatsoever in the use of IDB's, including some State and local officials.

One of the most controversial aspects of the proposal would doubtless be the application of the ACRS trade-off principle to all IDB's and not just to small issues. We support its broad application because the principle is the same no matter what the size or purpose of the tax-exempt bond: No taxpayer should have both the benefits of ACRS and tax-exempt financing.

Those that benefit from pollution control bonds will tell you certainly that they serve a public purpose. NLC has opposed pollution control bonds since 1976, because cleaning up air or water pollution from a clearly identifiable source is a responsibility that goes along with being a good corporate citizen. It's a cost of production that should be borne by the user of the services and goods and not by all taxpayers. They were originally intended to give industry incentives to deal with pollution problems and to ease the cost of retrofitting existing plants to meet Federal standards, but those bonds issued now are usually for new plant and equipment.

Some bond programs are like old categorical grant programs. We never go back to eliminate them once they have served their intended purpose.

While I have concentrated so far on IDB's, I do not want to down play our concern that the minimum tax proposal now under discussion could adversely effect the municipal bond market. To us, it would be inconsistent to help the market on the one hand with the IDB proposal, and on the other, deal it a blow with a minimum tax law. Including either interest for tax-exempt bonds or interest deducted on borrowings to purchase or carry tax-exempt bonds as one of the preference items of the minimum tax would simply lessen the advantages of buying or holding tax-exempt bonds for individuals and institutions.

Treasury has said that the banks will be the industry most effected by a minimum tax, and, as I said before, banks are our best customers.

We do not wish to quarrel with the idea that every person or business that earns income ought to pay some minimum tax. However, in the final analysis, while the incidence of a minimum tax may fall on banks or individuals, the economic burden will fall on States and local governments.

[The prepared statement of Mr. Guthman follows:]

STATEMENT
OF
RICHARD GUTHMAN, COUNCILMEMBER, ATLANTA, GEORGIA
FOR THE
NATIONAL LEAGUE OF CITIES
MARCH 17, 1982

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I AM RICHARD GUTHMAN, COUNCILMEMBER IN ATLANTA, AND CHAIRMAN OF THE NATIONAL LEAGUE OF CITIES' FINANCE, ADMINISTRATION, AND INTERGOVERNMENTAL RELATIONS POLICY COMMITTEE. I APPRECIATE YOUR GIVING ME THIS OPPORTUNITY, ON BEHALF OF NLC, TO PRESENT THE VIEWS OF CITY OFFICIALS ON TAX MATTERS BEFORE THE COMMITTEE. WHILE NLC HAS AN INTEREST IN SEVERAL TAX ISSUES THAT YOU WILL BE CONSIDERING IN THE COMING DAYS, I WILL CONFINE MY REMARKS TO TWO MATTERS: INDUSTRIAL DEVELOPMENT BOND AND MINIMUM TAX PROPOSALS.

MY PRIMARY PURPOSE HERE TODAY IS TO URGE THE COMMITTEE TO PASS LEGISLATION THAT WILL CONTROL THE ISSUANCE OF TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS BY STATE AND LOCAL GOVERNMENTS. I REALIZE IT IS HIGHLY UNUSUAL FOR LOCAL GOVERNMENT OFFICIALS TO BE ASKING THE FEDERAL GOVERNMENT TO DO WHAT SOME WOULD REGARD AS INTERFERRING WITH STATE AND LOCAL AFFAIRS, BUT THAT INTERVENTION IS NECESSARY IF WE ARE GOING TO PRESERVE THE MUNICIPAL BOND MARKET FOR PUBLIC PURPOSES. WE GENERALLY ENDORSE THE ADMINISTRATION'S PROPOSAL TO CONTROL IDB'S WITH SOME EXCEPTIONS THAT I WILL RETURN TO IN A MOMENT.

While we are joining hands with the Administration in working to pass this initiative, our reasons for doing so are not the same. One of the Administration's primary motivations for advancing this proposal is to pick up revenues for the Treasury. Burgeoning federal deficits are a concern to NLC, too, but it is the current poor health of the bond market, which threatens the availability of capital for basic infrastructure needs of the country, that drives our desire to see IDB's controlled. In addition, we believe that since IDB's are nearly universally available, practically for the asking, they have lost their effectiveness as an economic development tool for cities.

This is a problem we cannot solve ourselves. Any city or state that acts to restrict IDB issuance places itself at a competitive disadvantage with surrounding jurisdictions. Understandably, no one wants to be the first to cut back. To say that it can be handled on a state-by-state basis without federal legislation ignores reality. Abuses in the use of these bonds and the proliferation of IDB's have been well-known for the last two to three years; yet in that time no state has acted either to eliminate abuses or to restrict volume. Uniform national controls are needed.

With respect to minimum tax proposals, NLC urges the Committee not to pass any proposal that will adversely affect the municipal bond market. Including interest on tax-exempt

BONDS OR INTEREST DEDUCTIONS ON BORROWINGS TO PURCHASE BONDS AS A PREFERENCE ITEM IN A MINIMUM TAX WOULD REDUCE THE DEMAND FOR OUR BONDS AND FURTHER HARM AN ALREADY AILING MARKET.

I. INDUSTRIAL DEVELOPMENT BONDS

THE CONDITION OF THE MARKET

IT WILL COME AS NO SURPRISE TO YOU TO HEAR THAT CITIES HAVE BEEN FACING RECORD HIGH INTEREST RATES IN THE MUNICIPAL BOND MARKET THIS PAST YEAR. INTEREST RATE RECORDS HAVE BEEN OCURRING IN ALL THE MARKETS. WHAT IS PARTICULARLY DISTURBING, THOUGH, IS THE FACT THAT THE SPREAD BETWEEN TAX-EXEMPT AND TAXABLE RATES HAS NARROWED SUBSTANTIALLY. TRADITIONALLY, THE SPREAD BETWEEN LONG-TERM TAX-EXEMPT AND TAXABLE RATES HAS RUN ABOUT 30 TO 35 PERCENT, BUT IN 1981 THAT MARGIN SHRANK TO 10 TO 15 PERCENT. THE MARKET HAS RECOVERED SOMEWHAT NOW, BUT THE SPREAD REMAINS TOO SMALL.

THE SIGNIFICANCE OF THAT DEVELOPMENT IS THAT, WHILE ALL THE CREDIT MARKETS ARE PLAGUED BY OPPRESSIVELY HIGH INTEREST RATES, THE DEMAND FOR TAX-EXEMPT BONDS HAS FALLEN RELATIVE TO OTHER INVESTMENTS. ONE REASON FOR THIS IS THAT INSTITUTIONAL INVESTORS ARE STAYING AWAY FROM THE MARKET IN DROVES. FORTUNATELY FOR US, SOME OF THAT DEMAND HAS BEEN REPLACED BY INDIVIDUAL BUYERS OR ELSE THE MARKET WOULD HAVE COLLASPED LAST YEAR. THE OBVIOUS ATTRACTION FOR INDIVIDUALS IS THE RECORD HIGH INTEREST THEY CAN EARN - THAT IS GOOD FOR THEM BUT BAD

FOR THE ISSUERS WHO HAVE TO PAY THOSE RATES.

UNFORTUNATELY FOR MUNICIPAL ISSUERS, THERE ARE SIGNS THAT INTEREST RATES IN THE TAX-EXEMPT MARKET MAY STAY HIGH RELATIVE TO TAXABLE RATES EVEN IF THE ECONOMY MAKES A FULL RECOVERY. MOST ANALYSTS ARE PREDICTING THAT BANKS, WHICH HOLD ABOUT 42 PERCENT OF ALL MUNICIPAL DEBT, WILL NEVER REGAIN THEIR FULL APPETITE FOR BONDS BECAUSE THEY HAVE MOVED TO OTHER METHODS OF REDUCING THEIR TAX LIABILITIES.

IN ADDITION, THE ECONOMIC RECOVERY TAX ACT OF 1981 NOT ONLY LESSENED THE NEED FOR TAX SHELTER, IT MADE TAX SHELTER MORE READILY AVAILABLE. THE ACT LOWERED REGULAR TAX RATES, REDUCED THE TOP CAPITAL GAINS RATE, EXPANDED THE USE OF INDIVIDUAL RETIREMENT ACCOUNTS (IRA'S), SHARPLY REDUCED ESTATE TAXES, AND MADE OTHER SHELTERS, SUCH AS LEASING, MORE ATTRACTIVE. THESE CHANGES IN TAX LAWS FURTHER REDUCE THE DEMAND FOR BONDS.

WHAT WE SEE, THEN, IS A MARKET THAT TRULY RESPONDS TO SUPPLY AND DEMAND FORCES. INTEREST RATES ON BONDS HAVE INCREASED AS DEMAND HAS DECREASED. THERE IS LITTLE CITIES OR STATES CAN DO TO ADJUST DEMAND, BUT WE CAN ADDRESS THE MATTER OF SUPPLY. WE NEED TO, IN EFFECT, SET PRIORITIES ON THE USE OF LIMITED TAX-EXEMPT CREDIT AND IN DOING THAT WE MUST CONCLUDE THAT CLEAR PUBLIC NEEDS, SUCH AS THE BUILDING OF ROADS, BRIDGES, SEWERS, WATER LINES, AIRPORTS AND PUBLIC BUILDINGS, DESERVE A PREFERENCE OVER ESSENTIALLY PRIVATE PURPOSE NEEDS. WE BELIEVE THAT

THE ADMINISTRATION'S PROPOSAL ON IDB'S WOULD HELP TO ACHIEVE THAT ORDERING.

RIGHT NOW BONDS FOR OTHER THAN STATE AND LOCAL GOVERNMENT USES ARE BEING GIVEN A DEFACTO PREFERENCE IN THE MARKET. REGULAR STATE AND LOCAL GOVERNMENT GENERAL OBLIGATION AND REVENUE BONDS ACCOUNT FOR ONLY ABOUT HALF THE TOTAL LONG-TERM TAX-EXEMPT VOLUME; AS RECENTLY AS 1976 THEY ACCOUNTED FOR THREE-FOURTHS OF THE VOLUME. TAKING THEIR PLACE HAVE BEEN BONDS ISSUED FOR PRIVATE COMPANIES OR BONDS ISSUED BY OTHER THAN GENERAL PURPOSE STATE AND LOCAL GOVERNMENTS. PARTICUALARLY NOTICEABLE HAS BEEN THE GROWTH OF SMALL-ISSUE IDB'S, WHICH HAVE EXPLODED FROM $1.4 BILLION, OR 4 PERCENT OF THE LONG-TERM MARKET, IN 1976 TO AN ESTIMATED $10.5 BILLION, OR 19.5 PERCENT OF THE MARKET, IN 1981. POLLUTION CONTROL BONDS FOR PRIVATE INDUSTRY, WHICH HAVE AVERAGED $2.5 BILLION SINCE 1976, JUMPED TO $4.3 BILLION LAST YEAR. UTILITIES, WHICH NOT MANY YEARS AGO ISSUED VERY FEW BONDS, NOW ACCOUNT FOR ABOUT 19 PERCENT OF TOTAL VOLUME.

AS YOU KNOW, MOST BONDS ISSUED FOR BUSINESSES ARE BACKED BY THE CREDITWORTHINESS OF PRIVATE-SECTOR BENEFICIARIES. IRONICALLY, MANY BENEFICIARIES OF TAX-EXEMPT BONDS HAVE BETTER CREDIT-STANDINGS AND EASIER ACCESS TO CAPITAL THAN DO THE STATE AND LOCAL GOVERNMENT ISSUERS WHO ARE LENDING THEM THEIR TAX-EXEMPT PRIVILEGE OR WHO ARE COMPETING FOR CAPITAL IN THE SAME MARKETPLACE. STATE AND LOCAL GOVERNMENT ARE BESET BY A VARIETY OF FINANCIAL PROBLEMS BROUGHT ON BY CUTS IN GRANT AID, TAX AND SPENDING LIDS, SLOW TAX BASE GROWTH, AND GROWING LIABILITIES, ALL OF WHICH AFFECT THEIR ABILITY TO SERVICE DEBT. THE LENDING OF TAX-EXEMPTION TO PRIVATE BENEFICIARIES, THEREFORE, EFFECTIVELY ALLOCATES CREDIT AWAY FROM TRADITIONAL PUBLIC SECTOR NEEDS. CONSEQUENTLY, CITIES CAN'T SELL, OR DON'T BOTHER TO TRY TO SELL, BONDS FOR PUBLIC NEEDS WHILE CORPORATIONS BENEFIT FROM CHEAPER MONEY THAN COULD OTHERWISE BE OBTAINED IN THE PRIVATE MARKETS AND 100 PERCENT FINANCING FOR THEIR PROJECTS.

THE ADMINISTRATION PROPOSAL

WHILE WE ARE CRITICAL OF THE GROWING DOMINANCE OF IDB'S AND OTHER PRIVATE-PURPOSE BONDS IN THE TAX-EXEMPT MARKET, WE DO NOT THINK THEY SHOULD BE DONE AWAY WITH ENTIRELY. THERE IS JUSTIFICATION FOR GIVING TAX INCENTIVES TO ENCOURAGE URBAN REVITALIZATION, JOB CREATION OR RETENTION, AND THE ACHIEVEMENT OF OTHER PUBLIC NEEDS OUTSIDE THE GOVERNMENT SPHERE. THAT IS WHY WE THINK THE ADMINISTRATION PROPOSAL IS PARTICULARLY INGENIOUS: IT FORCES POTENTIAL PRIVATE BENEFICIARIES OF BONDS TO CHOOSE THE TAX BREAK THEY WANT, INSTEAD OF RECEIVING A TAX BREAK IN THE FORM OF ACCELERATED DEPRECIATION (I.E., ACRS) IN ADDITION TO TAX-EXEMPT FINANCING. MOREOVER, IT DOES NOT ELIMINATE ANY CURRENT STATUTORILY AUTHORIZED USES OF BONDS.

FURTHERMORE, NLC BELIEVES IT IS SOUND PUBLIC POLICY TO REQUIRE PUBLIC HEARINGS ON PROPOSED BOND-FINANCED PROJECTS AND APPROVAL OF BONDS BY DIRECTLY-ELECTED OFFICIALS, AS CALLED FOR IN THE ADMINISTRATION PROPOSAL. FOR PRACTICAL REASONS, BOND-ISSUING AUTHORITIES OF NON-ELECTED PEOPLE HAVE BEEN ESTABLISHED ACROSS THE COUNTRY. THEY SERVE IMPORTANT PURPOSES

IN MANY CASES, BUT THEY SHOULD NOT SERVE TO HIDE THE PUBLIC'S BUSINESS. THE GRANTING OF TAX-EXEMPTION IS SOMETHING THAT SHOULD BE DONE ONLY BY ELECTED OFFICIALS ACTING IN THE OPEN.

WE STRONGLY SUPPORT THE PRINCIPLE EMBODIED IN THE ADMINISTRATION PROPOSAL THAT THE ISSUER MUST BE FINANCIALLY INVOLVED IN THE PROJECTS TO BE ASSISTED FOR THE LAST SEVERAL YEARS NLC HAS HAD POLICY STATING THAT ISSUERS SHOULD BE ASSOCIATED BOTH "FUNCTIONALLY AND FINANCIALLY" WITH THE OBLIGATIONS CREATED THROUGH IDB'S. THIS INVOLVEMENT ASSURES THAT THE ISSUER HAS A STAKE IN THE PROJECT WHICH, IN TURN, HELPS ASSURE THAT THE PROJECT MEETS A PUBLIC PURPOSE. THERE ARE, HOWEVER, MANY TECHNICAL PROBLEMS WITH THIS PROVISION WHICH MUST BE ADDRESSED WHEN YOU WRITE THE LEGISLATION. NEARLY ALL STATES HAVE STATATORY OR CONSTITUTIONAL PROHIBITIONS ON "GIFTS OF PUBLIC FUNDS" TO PRIVATE PARTIES WHICH COULD CAUSE TREMENDOUS DIFFICULTY IN IMPLEMENTING THIS REQUIREMENT. DIRECT FINANCIAL CONTRIBUTIONS OF MOST KINDS TO A PROJECT COULD BE CONSTRUED TO BE A "GIFT OF PUBLIC FUNDS." THE REQUIREMENT MUST BE STRUCTURED VERY FLEXIBLY SO THAT A CONTRIBUTION CAN BE MADE "TO OR FOR THE BENEFIT OF" THE PROJECT ASSISTED. AN EXAMPLE WOULD BE THE PROVISION OF IMPROVED NEW SEWER LINES OR ROADS WHICH ARE NOT PART OF THE ACTUAL PROJECT ASSISTED WITH BONDS, BUT WHICH NEVERTHELESS WILL BENEFIT THE PROJECT.

AS I MENTIONED EARLIER, THERE ARE PARTS OF THE ADMINISTRATION PROPOSAL TO WHICH WE TAKE EXCEPTION. LET ME COVER THOSE POINTS.

WE OPPOSE THE REQUIREMENT THAT BONDS BE ISSUED IN REGISTERED FORM. THE PROPOSAL CALLS FOR REPORTING OF ALL BOND SALES, WHICH WE STRONGLY SUPPORT AND WHICH WE THINK MEETS THE LEGITIMATE NEED OF BEING BETTER ABLE TO TRACK ALL BOND ACTIVITY AT THE NATIONAL LEVEL. BOND REGISTRATION WILL MEAN HIGHER ISSUANCE COSTS, SOMETHING NLC HAS LONG SOUGHT TO REDUCE. THIS PROVISION GOES IN THE WRONG DIRECTION.

NLC IS ALSO TROUBLED BY THE PROVISION THAT WOULD PROHIBIT SMALL-ISSUE IDB'S FOR COMPANIES THAT MAKE CAPITAL EXPENDITURES OF MORE THAN $20 MILLION FOR A SIX-YEAR PERIOD BEGINNING THREE YEARS BEFORE AND ENDING THREE YEARS AFTER THE PROPOSED DATE OF ISSUANCE. WE KNOW THAT YOU FEEL STRONGLY ABOUT THIS PROVISION, MR. CHAIRMAN, AND SO LET ME EXPLAIN OUR DIFFERENCES. WE STRONGLY FAVOR THE VIEW THAT SMALL BUSINESSES OUGHT TO BE HELPED BEFORE LARGE CORPORATIONS WITH EASIER ACCESS TO CAPITAL; HOWEVER, WHEN IDB'S ARE USED FOR REDEVELOPING AN URBAN AREA, THE FEASIBILITY OF THOSE PROJECTS IS USUALLY DEPENDENT UPON ATTRACTING A LARGE, STABLE COMPANY. ONCE A COMMITMENT FROM A LARGE CONCERN IS MADE TO A REDEVELOPMENT PROJECT , OTHER INVESTORS TYPICALLY FOLLOW SUIT. WE THINK THIS PROVISION WILL TAKE AWAY WHAT WE FEEL IS THE PRIMARY JUSTIFICATION FOR SMALL-ISSUE IDB'S - THEIR USE FOR ECONOMIC AND PHYSICAL REVITALIZATION. WE WOULD ASK THAT THE PROVISION BE AMENDED TO MAKE EXCEPTIONS FOR SUCH PROJECTS.

ALONG THIS LINE, THE COMMITTEE SHOULD CONSIDER EXEMPTING THIS AND THE ACRS TRADE-OFF PROVISION IN CERTAIN ECONOMICALLY DETERIORATED AREAS. THE ADMINISTRATION HAS SAID IT WANTS TO LIFT THE ACRS-TRADE-OFF REQUIREMENT IN URBAN ENTERPRISE ZONES. WE WELCOME THIS TYPE OF TARGET-AREA FEATURE, BUT WE WANT TO WITHHOLD JUDGEMENT ON IT UNTIL THE ADMINISTRATION'S ENTERPRISE ZONE BILL IS SENT TO CONGRESS.

FINALLY, THERE ARE TWO OTHER ASPECTS OF THIS PROPOSAL WHICH WE WANT TO BRING TO YOUR ATTENTION. IT IS IMPORTANT TO DETERMINE THE IMPACT OF THIS LEGISLATION ON BOND PROJECTS THAT ASSIST LOW AND MODERATE INCOME MULTI-FAMILY HOUSING AND SOLID WASTE RESOURCE RECOVERY. WITH RESPECT TO MULTI-FAMILY HOUSING, YOU WILL RECALL THAT IMPORTANT NEW INCENTIVES FOR HOUSING PRODUCTION WERE PUT IN THE ECONOMIC RECOVERY TAX ACT LAST YEAR. THEY WOULD BE PARTIALLY UNDONE BY APPLYING THE ADMINISTRATION'S IDB RESTRICTIONS TO MULTI-FAMILY PROJECTS, AS IS PROPOSED. WHILE WE ARE NOT PREPARED TO OFFER SPECIFIC PROPOSALS IN THESE AREAS TODAY, WE DO WANT THE COMMITTEE TO BE AWARE THAT THESE PROJECTS THAT DO SERVE A PUBLIC PURPOSE COULD BE ADVERSELY AFFECTED.

AREAS OF CONTROVERSY

WE KNOW THAT PASSAGE OF LEGISLATION TO CONTROL IDB'S WILL NOT BE EASY BECAUSE OF THE TREMENDOUS POLITICAL OPPOSITION THAT WILL LIKELY SURFACE TO ANY CHANGES WHATSOEVER. THERE IS NOT UNANIMITY AMONG CITY OFFICIALS ON THIS ISSUE; MANY, IN FACT, STRONGLY FEEL THAT THEIR RIGHT TO ISSUE IDB'S SHOULD IN NO WAY BE IMPAIRED. AND, THERE ARE, OF COURSE, MANY PRIVATE PARTIES WHO DIRECTLY BENEFIT FROM IDB'S WHO WILL OPPOSE IT.

ONE OF THE MOST CONTROVERSIAL ASPECTS OF THE ADMINISTRATION PROPOSAL WILL DOUBTLESS BE ITS APPLICATION TO ALL IDB'S AND NOT JUST TO SMALL-ISSUES. WE SUPPORT ITS BROAD APPLICATION BECAUSE TO US THE PRINCIPLE IS THE SAME NO MATTER WHAT THE SIZE OR PURPOSE OF TAX-EXEMPT BONDS. NO TAXPAYER SHOULD HAVE BOTH THE BENEFITS OF ACCELRATED DEPRECIATION ENACTED LAST YEAR AND TAX-EXEMPT FINANCING.

IN MY CITY OF ATLANTA, FOR EXAMPLE, WE WILL STILL BE ABLE TO ISSUE BONDS TO BUILD A RUNWAY AT OUR AIRPORT UNDER THE ADMINISTRATION PROPOSAL. HOWEVER, IF WE ISSUE A TAX-EXEMPT BOND TO BUILD A FACILITY FOR AN AIRLINE, IT IS ONLY FAIR THAT AIRLINE GIVE UP ANY RIGHT TO TAKE ACCELERATED DEPRECIATION ON THAT PART OF THE FACILITY FINANCED WITH TAX-EXEMPT BONDS.

I SUSPECT THAT NOWHERE WILL THE CRIES OF PROTEST AGAINST THIS PROPOSAL BE LOUDER THAN FROM THOSE WHO BENEFIT FROM POLLUTION CONTROL BONDS. NLC SUPPORTS THEIR INCLUSION IN THIS PROPOSAL. IN FACT, WE HAVE HAD A POLICY SINCE 1976 THAT POLLUTION CONTROL BONDS WHICH SUPPORT PRIVATE FACILITIES OR IMPROVEMENTS THAT BEAR NO RELATIONSHIP TO TRADITIONAL MUNICIPAL SERVICES OR FUNCTIONS SHOULD BE ABOLISHED.

CLEANING UP AIR OR WATER POLLUTION FROM A CLEARLY IDENTIFIABLE SOURCE IS A RESPONSIBILITY THAT GOES ALONG WITH BEING A GOOD CORPORATE CITIZEN. THE COST OF THAT CLEAN-UP SHOULD BE BORNE BY THE USERS OF THE GOODS OR SERVICES PRODUCED AND NOT BY ALL TAXPAYERS.

When pollution control bonds were authorized in 1968, they were seen as an incentive for private industry to improve the environment. Later they were viewed as partial compensation for federal environmental mandates imposed on industry. It was thought that the bonds would be used for retrofitting plant and facilities, investments which might not be recoverable in prices charged for goods or services.

But, the job of retrofitting should be done by now. Pollution bonds being issued now are for new plant and equipment. These costs should be seen as costs of production and not something that should be subsidized by the federal government through loss of tax revenues or by state and local governments through loss of capital and increased interest costs on bonds.

Some bond programs are like categorical grant programs. We never go back to eliminate them once they have served their intended purpose.

Again, I would emphasize that all the Administration proposal would require is that a company that wants to use a tax-exempt bond give up a tax benefit that wasn't available to it just a year ago. Those that argue that they shouldn't have to do that are, in effect, admitting that they do not want to forego ACRS, which must mean that it is a very attractive tax break for them.

II. THE MINIMUM TAX

AT THIS POINT, I WANT TO TURN TO THE MATTER OF THE MINIMUM TAX PROPOSALS. FOR THE SAME REASONS I HAVE JUST GIVEN ABOUT THE NEED TO STRENGTHEN AND PROTECT THE MUNICIPAL BOND MARKET SO THAT PUBLIC NEEDS CAN BE MET, NLC MUST OPPOSE ANY ASPECT OF A MINIMUM TAX THAT COULD ADVERSELY AFFECT THE MARKET. UNFORTUNATELY, WE BELIEVE THAT THOSE PROPOSALS CURRENTLY UNDER DISCUSSION WILL HAVE THOSE ADVERSE EFFECTS.

UNDER THE ADMINISTRATION'S PROPOSAL FOR A MINIMUM CORPORATE TAX, ONE OF THE ITEMS TO BE ADDED BACK IN DETERMINING A COMPANY'S RECONSTRUCTED TAX BASE, IF IT IS SUBJECT TO THE MINIMUM TAX, IS INTEREST DEDUCTED ON BORROWINGS TO PURCHASE OR CARRY TAX-EXEMPT SECURITIES. THE TREASURY DEPARTMENT HAS STATED THAT THE INDUSTRY MOST AFFECTED BY A MINIMUM CORPORATE TAX IS BANKING, AND IT IS PRIMARILY BECAUSE OF THIS PROVISION RELATING TO BORROWINGS TO PURCHASE BONDS.

MR. CHAIRMAN, WE UNDERSTAND THAT YOU HAVE ALSO COME OUT IN FAVOR OF A MINIMUM TAX AND THAT YOU WOULD TAKE THE ADMINISTRATION'S PROPOSAL TWO STEPS FURTHER BY EXTENDING THE TAX TO INDIVIDUALS AND BY INCLUDING INTEREST EARNED ON TAX-EXEMPT BONDS AS ONE OF THE PREFERENCE ITEMS TO BE ADDED BACK IN DETERMINING THE TAX. IN OUR ESTIMATION, YOUR PROPOSAL WOULD HAVE AN EVEN MORE SERIOUS EFFECT ON THE MARKET. IN ADDITION, IT RAISES A CONSTITUTIONAL CHALLENGE ON THE BASIS THAT, IN EFFECT, IT MAKES TAX-EXEMPT BONDS TAXABLE.

IF EITHER OF THESE PROPOSALS IS ENACTED, THE LIKELY EFFECT WILL BE THAT BANKS WILL NOT BUY AS MANY MUNICIPAL BONDS AND/OR THEY WILL ADJUST THEIR PORTFOLIOS BY SELLING OFF BONDS. KEEP IN MIND THAT BANKS HAVE LONG BEEN OUR BEST CUSTOMERS, BUYING ABOUT 42 PERCENT OF ALL BONDS ISSUED. WE ARE ALREADY WORRIED THAT BANKS WILL NOT BE BUYING AS MANY BONDS IN THE FUTURE. A MINIMUM TAX IMPOSED ON THEM WILL ONLY EXACERBATE THE PROBLEM.

WE DO NOT WISH TO QUARREL WITH THE IDEA THAT EVERY PERSON OR COMPANY THAT EARNS INCOME OUGHT TO PAY SOME MINIMUM TAX. HOWEVER, WE WANT TO POINT OUT THAT WHILE THE EFFECTIVE FEDERAL TAX RATES BANKS PAY MAY GENERALLY BE LOW, THAT FACT MASKS THE SERVICE THEY PROVIDE TO STATES AND LOCAL GOVERNMENT IN BUYING OUR BONDS. IN THE FINAL ANALYSIS, WHILE THE TAX BURDEN IMPOSED BY A MINIMUM TAX THAT INCLUDES EITHER INTEREST ON BORROWINGS TO BUY BONDS OR INTEREST EARNED ON BONDS MAY FALL ON BANKS OR INDIVIDUALS, THE ECONOMIC BURDEN WILL ULTIMATELY REST WITH STATES AND LOCAL GOVERNMENTS.

STATEMENT OF HON. PETER SHAPIRO, COUNTY EXECUTIVE, ESSEX COUNTY, N.J., ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES

Mr. **Shapiro**. Thank you, Senator. Good morning. My name is Peter Shapiro. I'm the county executive of Essex County, N.J., and vice chairman of the Tax and Finance Steering Committee of the National Association of Counties.

I am testifying before you today on behalf of NACO, the only national organization that represents county government.

My remarks this morning will be directed toward two tax revision proposals by the administration: The first, to restrict the issuance of private purpose industrial revenue bonds by States and local governments; and the second, to include interest on indebtedness to purchase or carry tax-exempt securities in the calculation of a minimum tax on banking institutions.

Let me first address the issue of the proposed restrictions on IRB's, an issue vital to county governments. I was cochairman of NACO's task force on IRB's and I can tell you that it was a very difficult task for us—who represented a wide variety of county governments—to reach a consensus concerning appropriate restrictions on IRB's.

The resolution adopted by the task force and ultimately by NACO as a whole, emphasizes the important role that small issue IRB's have played in the stimulation of local capital investment and job creation. But it also acknowledges that in some instances abuses have occurred. And IRB financing has been of questionable value to economic development. Most important, the dramatic growth in the volume of these bonds from $1.3 billion in 1975 to $10 billion in 1981 has adversely effected the municipal bond market by crowding out traditional public purpose bond issues, and increasing the interest costs of jurisdictions issuing bonds.

NACO policy, therefore, supports some limitation at the Federal level on the use of small issue IRB's. Specifically, we agree with the proposed requirement that all small issue IRB's must be publicly approved by the highest elected official or elected governing body of the jurisdiction in which the bonds are being issued following a public hearing. We also agree that small issues should be reported, in order to determine their exact volume. Two other restrictions that we endorse have not been proposed by the Treasury. Namely, that retail commercial and recreational uses of small issue IRB's be eliminated for all but economically distressed areas, as determined locally, and that an issuing authority require the agreement by users of small issue IRB's to an equal employment opportunity commitment based on locally established guidelines. We feel that the imposition of these limitations would correct the abuses of small issue IRB's that have occurred, would guarantee that they serve the public purposes of stimulation of capital formation and job development, but would not so drastically curtail the volume of these issues as to render them an ineffective tool for economic development.

While we support some of the restrictions on IRB's proposed by the Treasury, we do not support others. First, we do not support the proposed requirement that users of small issue IRB's forgo the use of the accelerated cost recovery system under the 1981 Economic Recovery Tax Act. We feel that this restriction would drastically curtail the use of small issue IRB's by private concerns. Such a severe curtailment would destroy the ability of State and local governments to use IRB's as an economic incentive to attract industry. Jurisdictions that are economically distressed, especially, such as my own county of Essex, N.J., would be especially disadvantaged by this development.

The second proposed Treasury restriction that we oppose is the requirement that after December 31, 1985, a governmental unit issuing IRB's must make a financial contribution to the project equal to 1 percent of the face amount of the bond. Although we believe the Treasury Department attempted to grant State and local governments some flexibility in meeting this requirement, virtually anyone of those mentioned in the proposal would present significant difficulties, legal and otherwise, to State and local issuers. For example, the Treasury proposal states that 1 percent requirement could be met if the bonds issued were general obligations bonds and were guaranteed by the jurisdiction. Over 30 States now impose constitutional debt limitations on their localities.

Similar problems exist with virtually all of the other possible forms of financial contribution. And it is our feeling that this is an onerous requirement that would severely restrict the ability of jurisdictions to issue IRB's. This requirement would be particularly onerous in our most economically distressed areas, those most in need of the kind of economic activity that this financing is supposed to provide, and those least able to afford the 1 percent contribution.

Furthermore, we feel that if the purpose of the requirement is to insure that IRB's meet a public purpose, then it is perhaps redundant and unnecessary. The approval requirement that we are proposing and Treasury is proposing requiring the highest elected official to the governing body to approve it, would take care of that. The proposal contained here would be overkill.

A third proposed Treasury restriction that NACO opposes is the limitation on the use of small issue IRB's to small businesses, defined as those with capital expenditures of less than $20 million during the period from 3 years prior to 3 years after the issuance of the bonds. We support continuation of the existing capital expenditure limits because there are instances where the issuance of IRB's to finance a project of a large corporation can be very beneficial to economic development within a jurisdiction, especially if the jurisdiction is economically distressed. For example, major national corporations, including retail firms, need tax-exempt financing as an incentive to locate in distressed areas like the one that I come from, in fact. This is particularly something that will generate jobs, and it can be targeted toward those areas.

Finally, we oppose the Treasury proposal to further restrict investment of bond proceeds in an effort to clamp down on arbitrage earnings. This proposed regulation would appear to reflect the opinion of Treasury that some jurisdictions are, in a sense, profiting from the issue of small issue IRB's by investing bond proceeds in higher yielding securities. From the perspective of issuing jurisdictions, however, such investments simply represent prudent cash management, and offset administrative expenses incurred by the issuing authority.

The CHAIRMAN. I'll have to get out of here in a short while.

Mr. SHAPIRO. I'm sorry, Mr. Chairman. I guess the last area I wanted to touch on can be dealt with by Mr. Esser. I think, Jeff, you are going to touch on the question of the proposals on the minimum tax, which would effect us very adversely. I just want to underline how adversely that would be, Mr. Chairman. And Mr. Esser will, I think, touch upon that.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Shapiro follows:]

STATEMENT OF THE HONORABLE PETER SHAPIRO, COUNTY EXECUTIVE, ESSEX COUNTY, NEW JERSEY, ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES ON THE ADMINISTRATION'S BUDGET PROPOSALS BEFORE THE SENATE FINANCE COMMITTEE, MARCH 17, 1982.

GOOD MORNING. I AM PETER SHAPIRO, COUNTY EXECUTIVE OF ESSEX COUNTY, NEW JERSEY, AND VICE-CHAIRMAN OF THE TAXATION AND FINANCE STEERING COMMITTEE OF THE NATIONAL ASSOCIATION OF COUNTIES (NACo).* I AM TESTIFYING BEFORE YOU TODAY ON BEHALF OF NACo, THE ONLY NATIONAL ORGANIZATION THAT REPRESENTS COUNTY GOVERNMENT.

MY REMARKS THIS MORNING WILL BE DIRECTED TOWARD TWO TAX REVISION PROPOSALS BY THE ADMINISTRATION: THE FIRST, TO RESTRICT THE ISSUANCE OF PRIVATE PURPOSE INDUSTRIAL REVENUE BONDS BY STATE AND LOCAL GOVERNMENTS, AND THE SECOND, TO INCLUDE INTEREST ON INDEBTEDNESS TO PURCHASE OR CARRY TAX-EXEMPT SECURITIES IN THE CALCULATION OF A MINIMUM TAX ON BANKING INSTITUTIONS.

LET ME FIRST ADDRESS THE ISSUE OF THE PROPOSED RESTRICTIONS ON INDUSTRIAL REVENUE BONDS, AN ISSUE SO VITAL TO COUNTY GOVERNMENTS THAT NACo PRESIDENT RICHARD CONDER RECENTLY APPOINTED A SPECIAL TASK FORCE TO CONSIDER IT AND REFORMULATE NACo POLICY IN A RESPONSIVE WAY.

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* The National Association of Counties is the only national organization representing county government in the United States. Its membership spans the spectrum of urban, suburban, and rural counties which have joined together for the common purpose of strengthening county government to meet the needs of all Americans. By virtue of a county's membership, all its elected and appointed officials become participants in an organization dedicated to the following goals:

- improving county governments;
- serving as the national spokesman for county governments;
- acting as a liaison between the nation's counties and other levels of government; and
- achieving public understanding of the role of counties in the federal system.

I WAS CO-CHAIRMAN OF THAT TASK FORCE AND I CAN TELL YOU THAT IT WAS VERY DIFFICULT FOR TASK FORCE MEMBERS, WHO REPRESENTED A WIDE VARIETY OF COUNTY GOVERNMENTS, TO REACH A CONSENSUS CONCERNING APPROPRIATE RESTRICTIONS ON IRBs. IN THE END, THEY SUPPORTED RESTRICTIONS ONLY FOR SMALL-ISSUE INDUSTRIAL REVENUE BONDS, SINCE THEY FELT THAT CONTINUED, UNCHECKED GROWTH IN THAT AREA POTENTIALLY POSED SERIOUS PROBLEMS.

THE RESOLUTION ADOPTED BY THE TASK FORCE AND ULTIMATELY BY NACo AS AN ORGANIZATION EMPHASIZES THE IMPORTANT ROLE THAT SMALL-ISSUE IRBs HAVE PLAYED IN THE STIMULATION OF LOCAL CAPITAL INVESTMENT AND JOB CREATION. BUT IT ALSO ACKNOWLEDGES THAT, IN SOME INSTANCES, ABUSES HAVE OCCURRED AND IRB FINANCING HAS BEEN OF QUESTIONABLE VALUE TO ECONOMIC DEVELOPMENT. IN ADDITION, THE DRAMATIC GROWTH IN THE VOLUME OF THESE BONDS FROM $1.3 BILLION IN 1975 TO OVER $10 BILLION IN 1981 HAS ADVERSELY AFFECTED THE MUNICIPAL BOND MARKET BY CROWDING OUT TRADITIONAL PUBLIC PURPOSE BOND ISSUES AND INCREASING THE INTEREST COSTS OF JURISDICTIONS ISSUING BONDS.

CURRENT NACo POLICY, THEREFORE, SUPPORTS SOME LIMITATIONS AT THE FEDERAL LEVEL ON THE USE OF SMALL-ISSUE INDUSTRIAL REVENUE BONDS ONLY. SPECIFICALLY, WE AGREE WITH THE PROPOSED REQUIREMENT THAT ALL SMALL-ISSUE IRBs MUST BE PUBLICLY APPROVED BY THE HIGHEST ELECTED OFFICIAL OR ELECTED GOVERNING BODY OF THE JURISDICTION IN WHICH THE BONDS ARE BEING ISSUED FOLLOWING A PUBLIC HEARING. WE ALSO AGREE THAT SMALL ISSUES SHOULD BE REPORTED, IN ORDER TO DETERMINE THEIR EXACT VOLUME. TWO OTHER RESTRICTIONS THAT WE ENDORSE HAVE NOT BEEN PROPOSED BY THE TREASURY, NAMELY, THAT RETAIL COMMERCIAL AND RECREATIONAL USES OF SMALL-ISSUE INDUSTRIAL REVENUE BONDS BE ELIMINATED FOR ALL BUT ECONOMICALLY DISTRESSED AREAS, AS

DETERMINED LOCALLY, AND THAT AN ISSUING AUTHORITY REQUIRE THE AGREEMENT BY USERS OF SMALL-ISSUE IRBs TO AN EQUAL EMPLOYMENT OPPORTUNITY COMMITMENT BASED ON LOCALLY ESTABLISHED GUIDELINES. WE FEEL THAT THE IMPOSITION OF THESE LIMITATIONS WOULD CORRECT THE ABUSES OF SMALL-ISSUE IRBs THAT HAVE OCCURRED, WOULD GUARANTEE THAT SMALL-ISSUE IRBs SERVE THE PUBLIC PURPOSES OF STIMULATION OF CAPITAL FORMATION AND JOB DEVELOPMENT, BUT WOULD NOT SO DRASTICALLY CURTAIL THE VOLUME OF THESE ISSUES AS TO RENDER THEM AN INEFFECTIVE TOOL FOR ECONOMIC DEVELOPMENT.

WHILE WE SUPPORT SOME OF THE RESTRICTIONS ON SMALL-ISSUE IRBs PROPOSED BY THE TREASURY, WE DO NOT SUPPORT OTHERS. FIRST, WE DO NOT SUPPORT THE PROPOSED REQUIREMENT THAT USERS OF SMALL-ISSUE INDUSTRIAL REVENUE BONDS FOREGO THE USE OF THE ACCELERATED COST RECOVERY SYSTEM UNDER THE 1981 ECONOMIC RECOVERY TAX ACT. WE FEEL THAT THIS RESTRICTION WOULD DRASTICALLY CURTAIL THE USE OF SMALL-ISSUE IRBs BY PRIVATE CONCERNS. A RECENT ANALYSIS BY HAWKINS, DELAFIELD AND WOOD, A LAW FIRM WITH EXTENSIVE MUNICIPAL BOND EXPERIENCE, INDICATES THAT IRB FINANCING OF EQUIPMENT WOULD BE VIRTUALLY ELIMINATED BY REQUIRING USERS TO CHOOSE BETWEEN IRBs AND THE ACCELERATED COST RECOVERY SYSTEM. THIS IS BECAUSE OF THE CLEAR ADVANTAGE TO BE GAINED THROUGH A COMBINATION OF THE RAPID WRITEOFFS FOR EQUIPMENT, THE INVESTMENT TAX CREDIT AND SALEABILITY OF TAX BENEFITS UNDER THE NEW TAX LAW.

WITH REGARD TO REAL PROPERTY, THE ANALYSIS COMPARES THE PRESENT VALUE COSTS OF A REPRESENTATIVE PROJECT WHEN FINANCED BY IRBs AND WHEN FINANCED BY CONVENTIONAL METHODS AND DEPRECIATED UNDER ACRS. IT CONCLUDES THAT FEW COMPANIES WOULD SELECT IRB FINANCING. ONLY IF THE DIFFERENTIAL BETWEEN TAX-EXEMPT AND TAXABLE INTEREST RATES REACHES 7%, OR IF THE BORROWER IS IN THE LOWER FEDERAL CORPORATE TAX BRACKETS, IS AN ELECTION OF IRBs

LIKELY TO BE MADE. GIVEN THAT THE RATE DIFFERENTIAL IS NOT NOW NEAR THE 7% LEVEL AND THAT MOST IRB BORROWERS ARE IN THE HIGHEST FEDERAL CORPORATE TAX BRACKET, THE ANALYSIS INDICATES THAT THE PROPOSED TREASURY RESTRICTION WOULD SUBSTANTIALLY CURTAIL THE USE OF IRBs. SUCH A SEVERE CURTAILMENT WOULD DESTROY THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO USE IRBs AS AN ECONOMIC INCENTIVE TO ATTRACT INDUSTRY. JURISDICTIONS THAT ARE ECONOMICALLY DISTRESSED, SUCH AS MY OWN COUNTY OF ESSEX, NEW JERSEY, WOULD BE ESPECIALLY DISADVANTAGED BY THIS DEVELOPMENT.

THE SECOND PROPOSED TREASURY RESTRICTION THAT WE OPPOSE IS THE REQUIREMENT THAT AFTER DECEMBER 31, 1985, A GOVERNMENTAL UNIT ISSUING IRBs MUST MAKE A FINANCIAL CONTRIBUTION TO THE PROJECT EQUAL TO 1% OF THE FACE AMOUNT OF THE BOND. ALTHOUGH WE BELIEVE THE TREASURY DEPARTMENT ATTEMPTED TO GRANT STATE AND LOCAL GOVERNMENTS SOME FLEXIBILITY IN DETERMINING THE FORM SUCH A CONTRIBUTION COULD TAKE, VIRTUALLY ANY ONE OF THOSE MENTIONED IN THE PROPOSAL WOULD PRESENT SIGNIFICANT DIFFICULTIES, LEGAL AND OTHERWISE, TO STATE AND LOCAL ISSUERS. FOR EXAMPLE, THE TREASURY PROPOSAL STATES THAT THE 1% REQUIREMENT COULD BE MET IF THE BONDS ISSUED WERE GENERAL OBLIGATION BONDS OR WERE GUARANTEED BY THE JURISDICTION. OVER THIRTY STATES CURRENTLY IMPOSE CONSTITUTIONAL DEBT LIMITS ON THEIR LOCALITIES. IN ORDER TO ACCOMMODATE THE PROPOSED TREASURY REQUIREMENT, EITHER THESE STATE CONSTITUTIONS WOULD HAVE TO BE AMENDED — A LONG PROCESS THAT MOST LIKELY COULD NOT BE COMPLETED BY 1986 IN MANY STATES — OR LOCAL ISSUERS WISHING TO ISSUE GENERAL OBLIGATION BONDS FOR INDUSTRIAL DEVELOPMENT WOULD HAVE TO FOREGO ISSUANCE OF GENERAL OBLIGATION BONDS FOR TRADITIONAL PUBLIC PURPOSES. IT IS UNLIKELY THAT MANY JURISDICTIONS

WOULD ELECT TO DO THIS, ESPECIALLY SINCE THE CREDIT RATING FOR THEIR GENERAL OBLIGATION BONDS MIGHT SUFFER AS A RESULT OF FINANCING A PRIVATE CONCERN. SIMILAR PROBLEMS EXIST WITH VIRTUALLY ALL THE OTHER POSSIBLE FORMS OF FINANCIAL CONTRIBUTION, AND IT IS OUR FEELING THAT THIS IS AN ONEROUS REQUIREMENT THAT WOULD SEVERELY RESTRICT THE ABILITY OF JURISDICTIONS TO ISSUE IRBs. FURTHERMORE, WE FEEL THAT IF THE PURPOSE OF THE REQUIREMENT IS TO ENSURE THAT INDUSTRIAL REVENUE BOND ISSUES SERVE A LEGITIMATE PUBLIC PURPOSE, THEN IT IS PERHAPS REDUNDANT AND UNNECESSARY. THIS OBJECTIVE WOULD BE REALIZED THROUGH THE PROPOSED REQUIREMENT OF APPROVAL OF A BOND ISSUE BY THE HIGHEST ELECTED OFFICIAL OR GOVERNING BODY OF THE JURISDICTION IN WHICH THE BONDS ARE BEING ISSUED. ANY ADDITIONAL REQUIREMENT TO ACCOMPLISH THE SAME GOAL, ESPECIALLY ONE AS POTENTIALLY UNWORKABLE AS THIS, WOULD BE OVERKILL IN OUR OPINION.

A THIRD PROPOSED TREASURY RESTRICTION THAT NACo OPPOSES IS THE LIMITATION OF THE USE OF SMALL-ISSUE IRBs TO SMALL BUSINESSES, DEFINED AS THOSE WITH CAPITAL EXPENDITURES OF LESS THAN $20 MILLION DURING THE PERIOD FROM THREE YEARS BEFORE THROUGH THREE YEARS AFTER THE ISSUANCE OF THE BONDS. WE SUPPORT CONTINUATION OF THE EXISTING CAPITAL EXPENDITURE REQUIREMENTS BECAUSE THERE ARE INSTANCES WHEN THE ISSUANCE OF IRBs TO FINANCE A PROJECT OF A LARGE CORPORATION CAN BE VERY BENEFICIAL TO ECONOMIC DEVELOPMENT WITHIN A JURISDICTION, ESPECIALLY IF THE JURISDICTION IS ECONOMICALLY DISTRESSED. TO MODIFY THE EXISTING CAPITAL EXPENDITURE REQUIREMENTS IN SUCH A WAY AS TO LIMIT ALL IRB USE BY LARGE CORPORATIONS WOULD DESTROY THE FLEXIBILITY NOW PRESENT WITHIN THE SYSTEM TO ACCOMMODATE CASES WHERE SUCH USE CAN BE POSITIVE AND VALUABLE. AGAIN, THE PROPOSED REQUIREMENT THAT BOND ISSUES BE APPROVED BY THE HIGHEST ELECTED OFFICIAL OR GOVERNING BODY OF A JURISDICTION WOULD SUFFICE TO PREVENT MOST

USE OF IRBs BY LARGE CORPORATIONS WHEN SUCH USE WAS DEEMED UNSUITABLE OR UNNECESSARY BECAUSE OF THE AVAILABILITY OF PRIVATE FINANCING OR FOR SOME OTHER REASON. ACCORDING TO THIS SAME RATIONALE, WE ALSO OPPOSE THE LIMITATION ON CORPORATIONS OF $10 MILLION OF OUTSTANDING IRBs PROPOSED BY THE TREASURY.

FINALLY, WE OPPOSE THE TREASURY PROPOSAL TO EXTEND RESTRICTIONS ON THE INVESTMENT YIELD FROM THE USE OF THE PROCEEDS OF INDUSTRIAL REVENUE BONDS TO RESERVE FUNDS AND FUNDS HELD DURING THE TEMPORARY CONSTRUCTION PERIOD. THIS PROPOSED RESTRICTION WOULD APPEAR TO REFLECT THE OPINION OF TREASURY THAT SOME JURISDICTIONS ARE, IN A SENSE, "PROFITTING" FROM THE ISSUANCE OF SMALL-ISSUE INDUSTRIAL REVENUE BONDS BY INVESTING BOND PROCEEDS IN HIGHER YIELDING SECURITIES. FROM THE PERSPECTIVE OF ISSUING JURISDICTIONS, HOWEVER, SUCH INVESTMENTS SIMPLY REPRESENT PRUDENT CASH MANAGEMENT. IN MOST CASES, INVESTMENT PROCEEDS ARE USED TO REDUCE THE COST OF THE BOND ISSUE AND AS A HEDGE AGAINST UNFORESEEN INCREASES IN CONSTRUCTION COSTS DUE TO INFLATION.

THAT SUMMARIZES NACo'S RESPONSES TO THE TREASURY PROPOSALS CONCERNING THE RESTRICTION OF INDUSTRIAL REVENUE BONDS. BEFORE LEAVING THIS SUBJECT, HOWEVER, I WANT TO RAISE ONE ISSUE--THAT OF THE REVENUE LOSS TO THE FEDERAL TREASURY REPRESENTED BY THESE BONDS. THE CONGRESSIONAL BUDGET OFFICE ESTIMATED IN A STUDY LAST YEAR THAT THE LOSS TO THE TREASURY REPRESENTED BY SMALL-ISSUE INDUSTRIAL REVENUE BONDS WOULD BE $1.4 BILLION IN 1982, GIVEN A 10% RATE OF GROWTH IN THE VOLUME OF THESE BONDS. THE SIZE OF THIS REVENUE LOSS, IN A TIME OF BURGEONING FEDERAL DEFICITS, HAS BEEN ONE FACTOR THAT HAS PROMPTED THE PROPOSED RESTRICTIONS. IT SHOULD BE POINTED OUT, HOWEVER, THAT ACCURATE ESTIMATION OF REVENUE LOSS FROM SMALL-ISSUE IRBs IS NOT

EASILY DONE, SINCE IT IS NOT CERTAIN THAT ALL PROJECTS FINANCED BY INDUSTRIAL REVENUE BONDS WOULD BE FINANCED BY TAXABLE LOANS IF IRBs WERE UNAVAILABLE AND BECAUSE THE INCREASED ECONOMIC ACTIVITY GENERATED BY THESE BONDS AND THE ADDITIONAL TAXES PRODUCED BY THAT ACTIVITY PARTIALLY OFFSET ANY REVENUE LOSS. A 1980 STUDY BY NORMAN TURE, CURRENTLY UNDERSECRETARY OF THE TREASURY FOR TAX AND ECONOMIC AFFAIRS, CONCLUDES, IN FACT, THAT IF THE $10 MILLION SIZE LIMIT ON SMALL ISSUES WERE INCREASED TO $20 MILLION, IT WOULD PRODUCE A NET INCREASE IN FEDERAL REVENUES THROUGH INCREASED ECONOMIC ACTIVITY. BECAUSE OF THE DIFFICULTY IN DETERMINING THE LOSS, IF ANY, TO THE TREASURY REPRESENTED BY SMALL-ISSUE INDUSTRIAL REVENUE BONDS AND THE QUESTIONABLE ASSUMPTION THAT THIS LOSS SHOULD BE RECOUPED BY RESTRICTING WHAT MANY STATE AND LOCAL GOVERNMENTS CONSIDER TO BE A LEGITIMATE USE OF THEIR TAX-EXEMPT AUTHORITY, THE DEVELOPMENT OF NACo'S POLICY CONCERNING SMALL-ISSUE IRBs HAS BEEN STRUCTURED TO DEAL WITH WHAT WE PERCEIVE TO BE THE NEGATIVE EFFECTS OF THESE BONDS ON OUR OWN JURISDICTIONS, RATHER THAN ON THE FEDERAL GOVERNMENT.

NOW I WOULD LIKE TO ADDRESS BRIEFLY THE ADMINISTRATION'S PROPOSALS CONCERNING THE MINIMUM TAX ON CORPORATIONS; SPECIFICALLY, THE PROPOSAL TO INCLUDE INTEREST ON INDEBTEDNESS TO PURCHASE OR CARRY TAX-EXEMPT SECURITIES IN THE CALCULATION OF A MINIMUM TAX ON BANKING INSTITUTIONS. THE NATIONAL ASSOCIATION OF COUNTIES OPPOSES THIS PROPOSAL ON THE GROUNDS THAT IT WOULD HAVE AN ADVERSE IMPACT ON THE MUNICIPAL BOND MARKET. IT WOULD SIGNIFICANTLY REDUCE THE DEMAND FOR STATE AND LOCAL OBLIGATIONS FOR COMMERCIAL BANKS, CURRENTLY THE LARGEST INSTITUTIONAL HOLDERS OF MUNICIPAL SECURITIES, WITH CURRENT HOLDINGS OF $155 BILLION.

THE REDUCTION IN DEMAND FOR MUNICIPAL SECURITIES THAT WOULD RESULT FROM THIS PROPOSAL FOLLOWS HARD ON THE ECONOMIC RECOVERY TAX ACT OF 1981, WHICH HAS ALREADY REDUCED THE ATTRACTIVENESS OF MUNICIPAL BONDS TO INVESTORS BY REDUCING THE LATTER'S TAXABLE INCOME THROUGH A BATTERY OF MEASURES, INCLUDING A DECREASE IN THE TOP MARGINAL PERSONAL TAX RATE; A GENERAL REDUCTION IN THE PERSONAL TAX RATE; THE ACCELERATED COST RECOVERY SYSTEM; THE ALL SAVERS CERTIFICATES; CHANGES IN LEASING PROVISIONS; LIBERALIZATION OF INDIVIDUAL RETIREMENT ACCOUNTS; AND CHANGES IN ESTATE TAXATION. THESE MEASURES HAVE INCREASED COMPETITION FOR INVESTMENT AND EXERTED UPWARD PRESSURE ON INTEREST RATES OF MUNICIPAL SECURITIES. STATE AND LOCAL GOVERNMENTS ARE FINDING IT MORE DIFFICULT THAN EVER TO FINANCE PUBLIC PURPOSE PROJECTS IN A BOND MARKET THAT IS CHARACTERIZED BY RECORD HIGH INTEREST RATES AND A DECREASING YIELD DIFFERENTIAL BETWEEN TAXABLE AND NON-TAXABLE SECURITIES. AT THE SAME TIME, THESE JURISDICTIONS ARE BEARING THE BRUNT OF REDUCTIONS IN FEDERAL SPENDING AND THE REALIGNMENT OF FUNCTIONAL AND FUNDING RESPONSIBILITIES NECESSITATED BY THE NEW FEDERALISM. THEY ARE STRUGGLING GAMELY TO CONTINUE TO DELIVER SERVICES TO CITIZENS AND MAINTAIN THEIR CAPITAL INFRASTRUCTURE, BUT THEIR TASK WILL NOT BE MADE EASIER BY THIS TREASURY PROPOSAL.

A RECENT STUDY BY THE MUNICIPAL FINANCE OFFFICERS ASSOCIATION ESTIMATES THAT INCLUSION OF DEBT INTEREST DEDUCTIONS IN THE MINIMUM TAX BASE WILL REDUCE BANK DEMAND FOR TAX-EXEMPT SECURITIES BY 20 to 30 PERCENT OF THEIR CURRENT HOLDINGS. SURPLUS CURRENT HOLDINGS PRODUCED BY THIS DECREASED DEMAND WOULD EXERT UPWARD PRESSURE ON INTEREST RATES OF MUNICIPAL SECURITIES OF BETWEEN EIGHT-TENTHS OF ONE PERCENT TO TWO PERCENT, ACCORDING TO THE MFOA STUDY. THESE INCREASED INTEREST RATES WOULD FURTHER NARROW THE DIFFERENTIAL BETWEEN TAXABLE AND NON-TAXABLE SECURITIES AND CONSEQUENTLY RENDER MUNICIPAL SECURITIES LESS VALUABLE

TO GOVERNMENTS AS A FINANCING MECHANISM.

BECAUSE OF ITS PROBABLE ADVERSE IMPACT ON THE MUNICIPAL BOND MARKET, THE NATIONAL ASSOCIATION OF COUNTIES URGES THAT THIS PROVISION BE ELIMINATED FROM THE MINIMUM TAX PROPOSAL.

THAT CONCLUDES MY REMARKS. THANK YOU FOR PROVIDING ME WITH AN OPPORTUNITY TO APPEAR BEFORE YOU. I WILL BE HAPPY TO RESPOND TO ANY QUESTIONS YOU MIGHT HAVE.

STATEMENT OF JEFFREY L. ESSER, DIRECTOR, FEDERAL LIAISON CENTER, MUNICIPAL FINANCE OFFICERS' ASSOCIATION

The CHAIRMAN. Mr. Esser.

Mr. ESSER. Mr. Chairman, we've submitted our written statement for the record.

We appreciate this opportunity to appear before this committee to describe a municipal bond market headed for serious trouble and the role private purpose industrial revenue bonds are playing in the tax-exempt area.

We must report to you and to the distinguished local officials on this panel that the value of tax exemption is being severely eroded. As a consequence, the borrowing cost at the State and local levels of government are increasing faster than the general rise in interest rates.

With this as background, we have no choice but to oppose the inclusion of a preference item in any minimum tax which will either directly or indirectly affect the tax-exempt bond market.

Second, we encourage the U.S. Congress to pass legislation this year to restrict small issue industrial revenue bonds. While State and local governments share the difficulties of high interest rates that are a burden on all sectors of our economy, we have come in for some special problems in the last year. Let me briefly mention a few of the tax changes adopted in 1981 and their unintended effects on our market. The reduction in the personal income tax marginal rates, especially the lowering of the tax bracket from 70 percent to 50 percent and the associated reduction in the capital gains rate, the expansion of income sheltering opportunities in the retirement area, IRA and Keogh plans, and the creation of the tax-exempt all-savers certificates each have had an adverse impact on municipal bonds.

Expansion of the leasing opportunities, the investment tax credit and accelerated depreciation are reducing commercial bank demand for municipal securities.

On the other side of the ledger, there will be—in fact, there is increased pressure on our governments to borrow funds because of the cutbacks in Federal grant-in-aid both enacted last year and proposed this year, and in the new responsibilities that our governments may have to assume in an era of New Federalism.

On the minimum income tax, we do not find it within our province to advise this committee concerning the desirability of adopting a new minimum income tax on corporations. We must comment, however, on one of the 14 preference items recommended by the administration, which we feel would have a significant effect on the tax-exempt bond market.

As is detailed in our written statement, we feel that the inclusion of a preference item on the interest deductions for debt to carry tax-exempt securities would radically alter commerical bank purchases of both long-term tax-exempt bonds and short-term, tax-exempt securities.

We do not oppose this preference item on behalf of the financial institutions involved, but rather on behalf of State and local governments and our taxpayers who would end up financing the cost of this tax through higher interest payments on tax-exempt securities.

Given commerical banks current holdings of $155 billion in tax-exempt securities out of a total outstanding tax-exempt bond market of $361 billion, our calculations indicate that banks would reduce their holdings of municipal bonds on the order of 20 to 30 percent. Tax-exempt interest costs are estimated to increase then from $960 million to $1.6 billion in just the first year following the change in the tax law. While we do not foresee all of these changes occurring at once, the effect on tax-exempt interest rates would still be significant. Our current estimate, which we feel is conservative, is that tax-exempt interest rates would increase on the order of $1.3 billion.

One of the many pressures described in our written testimony that is causing a significant problem in the tax-exempt bond is the use of tax-exempt bonds for private purposes. We believe that small issue industrial revenue bonds are ripe for congressional consideration, especially in light of the large volume, which Dr. Rivlin described, and the uncontrolled uses of these bonds.

The MFOA opposes the use of tax exempt small issue industrial revenue bonds unless they are used in areas of serious economic deprivation. We believe that the cornerstone of the administration's proposal in this area, denying the use of accelerated depreciation to beneficiaries of industrial revenue bonds, ought to be applied to the small issue bonds.

Furthermore, we believe that small issue industrial revenue bonds should be targeted and used as an economic development tool if this restriction were not applied in areas suffering serious economic deprivation.

Thank you.

[The prepared statement follows:]

TESTIMONY OF THE MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. Chairman, we appreciate this opportunity to appear before the Senate Finance Committee to explain the severe consequences that the 1981 tax and budget actions have had on state and local government finance. We must also report to you that the value of tax exemption is being severely eroded and, as a consequence, the borrowing costs for state and local governments are increasing faster than the general rise in interest rates. While state and local governments share the difficulty of high interest rates that are a burden on all sectors of our economy, we have come in for some special problems in the last year. An additional factor which is affecting tax-exempt interest rates is a large-volume of private-purpose, tax-exempt borrowing. It is for this reason

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* The Municipal Finance Officers Association represents 9,000 members who are state and local government finance officials, appointed or elected, and public finance specialists. MFOA is headquartered in Chicago, Illinois, and also maintains a Washington, D.C., office.

that we encourage the U.S. Congress to pass legislation this year which will restrict small-issue industrial revenue bonds. With this as background, we have no choice but to strongly oppose the inclusion in any minimum income tax a preference item which would, directly or indirectly, affect the tax-exempt bond market.

I. Municipal Bond Market

Taken all together, the combination of significant cutbacks in Federal grant-in-aid funds to state and local government, the unintended effects of the Federal tax law enacted last year, and the monitary policies of the Federal Reserve Board have represented a triple whammy for state and local government finances. First, the budget actions have brought on severe reductions in grant-in-aid receipts for state and local governments. Second, in the municipal bond area there have been some adverse, unintended impacts resulting from the 1981 tax revisions. Third, crowded and uncertain capital market conditions accompanying continued Federal deficits and tight monitary policies have forced our governments to radically alter their plans for the capital construction necessary to maintain the infrastructure in our states, cities, and counties.

Tax-exempt interest rates have spiraled to over 13 percent (Bond Buyer 20-Bond Index) and the traditional gap between taxable and tax-exempt rates is closing rapidly. Thus, as a consequence, tax exemption, as a means of decreasing the borrowing costs of state and local governments, is slowly losing much of its value.

Changes enacted in the Economic Recovery Tax Act of 1981 will cause systematically higher interest rates of interest for municipal bonds compared to those on taxable securities. Looking first at those provisions of the Tax Act that affect individual taxpayers, several will have an adverse impact on tax-exempt interest rates:

- The reduction in personal income tax marginal rates, especially the lowering of the top bracket from 70 percent (on unearned income) to 50 percent for all income.
- The associated reduction in the capital gains rate, which will drop from a maximum of 28 percent to 20 percent, thereby improving the attractiveness of equity holding in relationship to fixed-income securities.
- Expansion of income-sheltering opportunities in individual retirement savings plans (IRA and Keogh).
- Partial exemption of interest income and indexation of marginal tax brackets, commencing in 1985.
- The creation of the All Savers Certificate which has resulted in a superior tax-exempt, short-term instrument that is federally guaranteed.

Looking at corporate purchases of municipal bonds, the following provisions in the new tax law will have adverse impacts: expansion of leasing tax shelters, increase in the investment tax credit, and accelerated depreciation schedules which, along with the ITC, will both enhance the rate of return on alternative investments and lessen the need for tax shelter from municipal securities. Expansion of these opportunities may prove to be especially significant in further reducing commercial bank demand for municipal securities.

Looking at the demand for municipal bonds, there were several negative trends which also started last year. Demand for tax-exempt bonds by institutional investors, namely commercial banks and casualty insurance companies, practically evaporated. Correspondingly, individuals (including mutual funds) acquired two-thirds of all state and local debt last year. Commercial banks and fire casualty insurance companies — which in the late 1970s acquired 80 to 90 percent of net increases in municipal bonds — have shown only minimal interest over the past few years. This pattern of demand illustrates the critical importance of the individual investor to the municipal securities market, and the higher yields which are necessary to attract these individuals to purchase municipal bonds.

On the other side of the ledger, there will be increased pressure on our governments to borrow funds, because of the cutbacks in Federal grant-in-aid approved last year and those proposed in the current Federal budget. For example, Federal grants over the last decade have financed approximately 37 percent of all state and local construction spending. Sharp reductions in those grants will require increased borrowing if the projects are to go forward. The tax-exempt bond market simply cannot accommodate this increased public purpose borrowing with the high level of private purpose borrowing that is projected in the next five years.

For the above reasons, the long-term prognosis for the tax-exempt bond market is not good. This is not to say that tax-exempt interest rates will not drop when other rates drop, but rather, in relationship to taxable rates, they will remain at much higher levels than we have seen traditionally.

II. The Effect of the Administration's Minimum Income Tax on State and Local Governments

We do not find it to be within our province to advise this Committee concerning the desirability of adopting a new minimum tax on corporations. But, we must comment on one of the 14 preference items recommended by the Administration which we believe would have a significant effect on the tax-exempt bond market.[1] We do not oppose this preference item on behalf of the financial institutions involved but, rather, on behalf of state and local governments and our taxpayers who would end up financing at the state and local level the cost of this Federal tax through higher interest payments on tax-exempt securities.

Inclusion of a pro-rated share of interest costs in the minimum income tax base would fundamentally change the demand of commercial banks for tax-exempt securities, further lessening the advantage to banks in owning those securities and, thereby, driving up interest rates. Interest rates on tax-exempt securities are already at an all-time high. The Economic Recovery Tax Act and the Budget Act of last year struck devestating blows, both directly and indirectly, at state and local finances and the municipal securities market. We do not think that state and local governments, nor the municipal bond market, should have to sustain yet another devestating blow in the formulation of Federal tax policy.

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[1] Preference item Number 9 in the Administration proposal states, "(9) deductions for debt to buy or carry tax-exempt securities."

Nonetheless, by enacting this measure, the Congress would be greatly lessening the desirability of municipal security holdings for our largest investor, commercial banks. Commercial banks continue to be the mainstay of the municipal bond market. Altogether, these financial institutions at present hold approximately 45 percent of outstanding municipal securities. Furthermore, bank ownership is especially crucial in the shorter maturities, which is the rapidly growing area of the market given the lack of credit and its high cost in the longer maturities.2/

As has been frequently cited, bank demand is crucial to the health of the municipal bond market. In view of the fact that commercial banks hold such a large proportion in municipal securities, any action that greatly weakens their demand will have severe adverse impacts on that market. Bank demand can change rapidly. As of September 1981, commercial banks held an estimated $20 billion in short-term, tax-exempt securities (those due in less than one year) and probably another $10 - 15 billion in bonds maturing within a year. Thus, banks have the capacity to alter their portfolios rapidly to reflect the changing advantage of different security holdings. While this represents a source of overall liquidity to banking institutions, it also poses a threat of an immediate drying-up of bank demand for new securities, as older securities are allowed to mature without replacement.

Right now, the pressure on the municipal bond market is particularly severe. Banks have not been increasing their holdings of municipal securities at a pace which would provide ready access to the market. On the other hand, banks have been maintaining their existing holdings of tax exempts, largely replacing maturing bonds and notes with new purchases. With the imposition of a minimum

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2/ We estimate that banks hold $20 billion of the approximately $25 to $30 billion in short-term, tax-exempt debt outstanding.

tax on the interest on borrowing arbitrarily allocated to tax-exempt security holdings, it is our belief that bank demand for municipals would decline drastically.

At present, we are pursuing analysis which we believe will provide reasonable estimates as to the impact of that decline on tax-exempt interest rates. Our current estimate is that the inclusion of interest on debt used to purchase and carry tax-exempt bonds in the minimum tax would decrease commercial bank desired holdings of municipal securities on the order of 20 to 30 percent. The minimum tax would move banks from the current situation of slowly acquiring municipal securities, to finding themselves with a large surplus of these securities. This change in desired holdings would have disastrous implications for interest rates in the tax-exempt market.

A major reason for these adverse outcomes is that, aside from the commercial banks, the other major institutional investor in tax-exempt bonds are the property and casualty (non-life) insurance companies. At present, their demands for tax-exempt securities are depressed with little prospect for immediate recovery. Once the two major institutional investors (banks and casualty insurance companies) are removed, there remains only the household sector, which is fundamentally made up of individual investors. Sales of municipal securities to these investors are expensive because high yields are required to attract and retain individuals who find their income tax burdens steadily declining and, thus, tax exemption is of less savings to them. Also, the average size of transaction is smaller and more costly than those involving institutions.

Using one line of analysis in a study we are now conducting, we tentatively have found that as a result of the imposition of the minimum tax, bank demand for tax-exempt securities would be lowered on the order of 20 to 30 percent of their current holdings of tax-exempt securities. Given the banks' current holdings of $155 billion tax-exempt securities, our calculations indicate that banks, in following profit-maximizing behavior, would want to hold only approximately $112 billion, were the minimum provision tax in effect with regard to the taxation of interest cost deductions.

The discrepancy of $43 billion between the present and desired bank holdings of tax-exempt securities is the focal point of calculating the interest rate impacts and the reduced availability of credit to state and local issuers. In view of the fact that banks currently hold $20 billion in tax-exempt notes and, perhaps, another $15 billion in longer-term securities maturing within one year, the downward adjustment in bank holdings might take place very rapidly. Banks might simply stop buying new tax-exempt securities and, as a result, what has been traditionally one-half of the market demand for our obligations would disappear overnight and for one year's duration. We doubt that would happen, but a substantial and continuing depression in bank demand, as they reduced municipal holdings in their portfolios, would be a certainty.

Prior analysis has estimated that $1 billion in added supply increases tax-exempt bond rates by 3 to 5 basis points. Using those estimates, a $40 billion surplus in bank holdings would generate an 120 to 200 basis point upward pressure on tax-exempt yields, given the level of taxable interest rates.

As Table 1 indicates, as of early 1982, the tax-exempt bond rates have been approximately 13 percent. Municipal bond yields have averaged approximately 80 percent of the yield on comparable taxable securities (which recently have been around 16 percent). An added 120 to 200 basis points would mean tax-exempt rates of 14 to 15 percent — very high, but by no means unheard of in the tax-exempt market these days. Correspondingly and more significantly,

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NOTE: A basis point equals one one-hundredth (1/100) of a percent.

the ratio of tax-exempt to taxable yields could climb to 85 or 95 percent, were taxable yields not to change in value. At such high ratios, tax-exempt securities would lose practically all value to governments as a means of lowering borrowing costs.

We do not foresee that dire result occurring all at once, but the direction of the pressure is clearly evident. If we suppose the true impact to be roughly the mid-point of the possible impact, the market would experience a 160 basis-point increase in tax-exempt rates, on average. At an $80 billion annual level of municipal bonds ($50 billion long-term and $30 billion short-term) this works out to an added $1.3 billion a year in tax-exempt borrowing costs, looking only at the first-year costs.

According to the information released by the Treasury Department on February 26, 1982, the minimum income tax proposal would be expected to produce additional federal revenue of $4.8 billion in 1984. This, added to the current minimum income tax collections, would produce a total of $5.3 billion in that same year. The Treasury Department estimates that 2.9 percent of their minimum income tax will be collected from banking institutions, or approximately $153 million in 1984.

Even if we assumed that most of this revenue would flow from taxing the interest deduction preference item, it appears that the federal government would pick-up a very small amount of revenue ($153 million) compared to the costs which would be imposed on tax-exempt borrowers ($1.3 billion).

Our opposition to this preference item is based on equity and economic hardship — the Administration has proposed turning over responsibilities to us, but this proposal from the Administration would make it very difficult for us to finance these new government programs at the state and local levels of government.

III. Industrial Revenue Bonds

The Municipal Finance Officers Association has testified before Congress on a number of occasions in opposition to the use of tax-exempt bonds that only benefit private industries and are not functions of state and local government. To be specific, in 1968, we adopted a policy which has formed the framework of our concerns in this area. This policy states that bonds which, regardless of purpose, are, in practical effect, the obligations of private industries with state and local governments acting only as conduits for private borrowing should not be continued in the tax-exempt bond market.[3] In 1975, we indicated to Congress our opposition to pollution control bonds and in 1978, we opposed the expansion of the small-issue limit, because at that time we predicted that increasing the limit from $5 million to $10 million would lead to an unwarranted proliferation of small-issue industrial revenue bonds.

At this time, we feel Congress should devote attention to adopting restriction on small-issue industrial revenue bonds. Our Association has two principal concerns about the present use of small-issue IRBs. First, small-issue IRBs are occupying an increasing share of the tax-exempt bond market. The 1981 level is estimated at approximately 10.5 billion, or 20 percent of the market. Second, the universal availability of small-issue IRBs in practically every state and community does not give any area an advantage in an economic development sense and may, in fact, promote the flight of downtown businesses away from our urban areas.

The MFOA has carefully studied the market for tax-exempt bonds and through this research, we have expressed legitimate concerns about its capacity to absorb, without cost, so-called conduit bonds. Small-issue IRBs must be examined along with all other conduit IRBs in order to fully understand their cumulative effect on the municipal bond market.

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[3] "Conduit bonds" refer to industrial development bonds for which the issuing local government has no financial involvement with its own resources and also has no functional involvement in that the facility financed is one which it could not itself operate as its own public facility.

Of major concern to state and local governments is the extent to which small-issue and other IRBs are crowding out the market for conventional state and local debt issues, absorbing capital that would normally go to the financing of traditional governmental activity and driving up the costs of borrowing for all tax-exempt issuers. Research over the years has documented that the laws of supply and demand hold true in the tax-exempt market: the greater the demand for funds in relationship to the supply of savings at any given time, the higher will be the interest rates in the tax-exempt market.

Quantifying the impacts of increased supply of tax-exempt securities on the availability and cost of credit is difficult. Research findings indicate that the rapid growth and large volumes of credit demands do exert upward pressure on rates of interest and difficulties for traditional governmental borrowers that must compete for credit with new claimants. At current market levels, it is estimated that an increase of $1 billion in tax-exempt securities can be expected to generate interest rates that are 3 to 5 basis points higher for the overall market than otherwise would be the case.4/ For smaller debt issues that depend on support from local markets (and where there may be a high degree of substitution by investors between the traditional debt and that being sold for nontraditional purposes) the impact of increased volume on interest rates and credit availability can be much greater. For example, small issuers in states where there is a large amount of IRB financing would see their borrowing costs going up by a

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4/ For a review of recent studies regarding the interest rate effects of incremental supplies of tax-exempt bonds, see Ronald Forbes, et. al., "An Analysis of Tax-Exempt Mortgage Revenue Bonds," Municipal Study Group, State University of New York at Albany (May 1979) Appendix III.

larger factor than would be true elsewhere in the market as a whole because of competition for local investment funds.[5]

The Treasury estimate of $10.5 billion in sales in 1980 of small-issue IRBs would imply that state and local borrowing costs, as reflected in rates of interest, were 31 to 52 basis points higher that year than they otherwise would have been. At an annual level of $50 billion in municipal bond sales, this implies increased annual borrowing costs of $155 to $260 million annually for each year that bonds sold in a given year remain outstanding. Thus, were the municipal securities to be outstanding for an average of 12 years, the total added costs in increased interest over the life of the debt would range between $1.9 billion and $3.1 billion.[6]

It should be pointed out that these numbers relate only to the 1981 sales figures for IRBs. If, in fact, the volume of IRB new issues rises as forecasted by the Congressional Budget Office, the increased borrowing costs would rapidly cumulate for all state and local borrowers.

Commercial bank purchases of industrial revenue bonds is not a healthy sign, in the long term, for the traditional municipal bond market. The CBO study estimates that 70 to 80 percent of small-issue sales are private placements.[7] Since most small-issue IRBs are privately placed with banks, there are limited opportunities for the banks to sell these tax-exempt securities. Banks may be filling their portfolios with tax-exempt IRBs and, therefore, lessening their ability to purchase tax-exempt bonds for schools, sewers, and street projects. With commercial banks maintaining their role as the single-largest holders of tax-exempt bonds,[8/] any shift in their demand for general obligation (or tax-supported) bonds for governmental purposes is a disturbing sign for state and local governments. If tax-exempt IRBs continue to play a major role in providing capital financing for business and industry, then the traditional municipal bond market is headed for troubled waters.

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[5] For an analysis of the local market impacts of increased offerings, see Hendershott, Patric and David Kidwell. "The Impact of Relative Security Supplies: A Test with Data from a Regional Tax-Exempt Bond Market." Journal of Money, Credit and Banking. February 1978.

[6] The present value of $1.9 billion and $3.1 billion, assuming an annual inflation rate of 10 percent over the 12 years, is $600 million and $990 million.

[7] CBO, Small Issue Industrial Revenue Bonds, p. 15.

The Use of Small-Issue Industrial Revenue Bonds as an Economic Development Tool

Many witnesses will submit testimony to this Committee indicating that small-issue industrial revenue bonds are an important economic development tool. They will tell you of the many jobs created through their use and of the firms that would not be able to build new facilities or expand existing facilities without this subsidy. The evidence simply does not support these claims. The universal availability of small-issue IRBs does not currently provide any individual community with a competitive advantage. One of the recent studies on this subject, by Margaret E. Dewer[9/] examined how effective IRBs are in influencing a corporation's location and expansion decision. According to Dewar:

> . . . the importance of the interest rate subsidy and other advantages of using the bonds is not likely to outweigh the importance of location criteria such as the cost of shipping products or the cost of acquiring suitable land. If other location characteristics dominate the decisions, the bonds probably have virtually no effect on location and expansion choices. In that case, the major result of bond programs is to reward firms for behaving as they would without the programs.[10/]

[8/] See Federal Reserve Board, Flow of Funds Accounts.

[9/] Dewar, Margaret E., The Usefulness of Industrial Revenue Bond Programs for State Economic Development: Some Evidence from Massachusetts, Working Paper No. 63, Joint Center for Urban Studies of the Massachusetts Institute of Technology and Harvard University, March 1980.

[10/] Ibid, pp. 1-2.

The Municipal Finance Officers Association believes that small-issue IRBs could be used as an effective economic development tool if they are restricted to areas of serious economic deprivation. Instead of providing a subsidy so that firms can flee our downtown areas, we ought to be encouraging economic development in areas of serious economic deprivation. If the Congress agrees with the Administration's recommendation to prohibit the use of the accelerated cost recovery system of depreciation in combination with IRBs, we encourage Congress to lift that restriction when the small-issue IRBs are used in areas of serious economic deprivation.

The Need for Federal Legislation

The MFOA adopted, at its last Annual Meeting, a policy supporting Federal restrictions in small-issue IRB area. Our Association came to the conclusion that this is an area in need of restrictions at the Federal level of government. Many of the state and local officials who are members of our Association have tried to restrict small-issue IRBs at the state and local level of government but have come to the conclusion that it is extremely difficult, if not impossible, for any state or, for that matter, local government to ban or severely restrict IRBs when neighboring communities and states continue to offer them. State legislatures which have attempted to pass IRB restrictions have not been able to overcome this argument. It is our belief that the current small-issue IRB climate leads to negative and unhealthy competition among the states and unless Federal restrictions are adopted, the use of small-issue IRBs will continue unabated.

Comments on the Administration's Proposal

We applaud the Administration for proposing restrictions on industrial revenue bonds to the U.S. Congress. While we do not fully support all of the recommendations contained in the Administration's IRB proposals, we find their support of restrictions encouraging.

The cornerstone of the Administration's bill proposing a trade-off between the use of tax-exempt bonds or ACRS depreciation should be supported by Congress. As indicated above, we would like to see this restriction lifted for small-issue IRBs in areas suffering serious economic deprivation.

The most serious problem with the Administration's proposal is the requirement that the state or local government make a financial contribution to a project which might be financing a private corporate activity. Most state constitutions deny state or local governments the power to donate or lend money or credit to private individuals. The practice of state governments borrowing for the benefit of private enterprise reached its peak in the 1850s when states competed in efforts to attract railroads. Subsequent large-scale bond defaults during the Depression of 1870 caused strong public reaction to the lending of state credit to individuals or corporations. Many states adopted constitutional amendments to prevent a reoccurrence of such practices. Based on experience, we believe that it would be difficult, if not impossible, for the states with such restrictions to amend their constitutions or laws prior to December 31, 1985. Such a restriction would, therefore, make industrial revenue bonds unworkable in most of the states.

We agree that it is important to secure the approval of the elected officials in the local government for industrial revenue bond projects. This approval can be achieved by requiring a public hearing on the projects and also by requiring approval of the projects by the elected legislative body of the governmental unit. This hearing and approval process will bring the IRB projects to the public view and will also hold local government officials accountable for the use of tax-exempt credit for the projects.

The Administration has also proposed restrictions in the area of arbitrage. When Congress adopted the 1968 legislation concerning industrial revenue bonds, it listed in the Code purposes which were allowable for industrial revenue bonds. Some of those items are only for private industries while others, such as municipal parking facilities, mass transportation, and airports, can be for governmental activities. We do not object to the placing of restrictions on industrial revenue bonds which are strictly conduit bonds. We do think, however, that the Administration's arbitrage proposal would be too far reaching and might affect governmental projects and, therefore, it needs to be carefully examined and then redrafted by Congress.

The Administration has also suggested that information on each industrial revenue bond be reported to the Internal Revenue Service. We think that the paperwork and administrative requirements generated by this requirement would be too cumbersome. Instead, we suggest that each state be required to gather information on industrial revenue bond sales and, in turn, report that information to an independent Federal body such as the Advisory Commission on Intergovernmental Relations or similar entity.

Conclusion

The question before us today is: Will the tax-exempt market continue to be available to finance the facilities of state and local governments in an economical way? Will general obligation bonds and those supported by other tax revenues be able to sell in the future? To those who point to the jobs and economic benefits of industrial revenue bonds we must ask this: If we cannot finance our streets, highways, bridges, water and sewer facilities, ports, and transit facilities with tax-exempt bonds, will we have the necessary infrastructure in place to support the activities of the industrial enterprises which they would like to see financed with tax-exempt bonds? If we decide that tax-exempt bonds are needed to finance state and local government facilities, then the uncontrolled issuance of industrial revenue bonds must be stopped.

TABLE 1

BOND BUYER 20 BOND INDEX (TAX-EXEMPT), MOODYS ALL-INDUSTRY CORPORATE BONDS (TAXABLE), AND RATIO OF RATES:

1978 to 1982.I

Year/Quarter	Bond Buyer 20 Bond Index (Tax-Exempt)	Moody's All-Industry Corporate Bonds (Taxable)	Ratio Of Tax-Exempt To Taxable (%)
1978 (yr.)	6.07 %	9.07 %	66.9 %
1979 (yr.)	6.53	10.12	64.5
1980/I	8.56	12.80	66.9
1980/II	7.86	12.32	63.8
1980/III	8.79	12.30	71.5
1980/IV	9.61	13.67	70.3
1981/I	9.97	14.09	70.8
1981/II	10.68	14.89	71.7
1981/III	12.03	15.65	76.9
1981/IV	12.59	15.64	80.5
1982/I*	13.13	16.09	81.6

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* First two months data

The **Chairman**. Thank you very much.

Senator Byrd?

Senator **Byrd**. Mr. Guthman, what does Atlanta need to pay to finance the GO's, and what is the highest rate that you have to pay on the GO's?

Mr. **Guthman**. Senator, our last GO issue, which was sold last fall, carried a rate of just over 9 percent which was the highest rate the city had ever paid.

Senator **Byrd**. What was it?

Mr. **Guthman**. Just over 9 percent. And we, have a AA credit rating. We anticipate selling some revenue bonds for our airport, and that is probably going to be over 14 percent.

Senator **Byrd**. What will be 14 percent?

Mr. **Guthman**. Some revenue bonds to be used to build a fourth runway at our airport.

Senator **Byrd**. It will be 14 percent tax exempt?

Mr. **Guthman**. Yes, sir.

Senator **Byrd**. What does Essex County pay?

Mr. **Shapiro**. Senator, because the market is so bad, we haven't sold long-term bonds, period, since 1979. And that is not an uncommon thing you will find among local governments. We are going on short-term financing exclusively.

The New York Times, yesterday, in their business section reported that the average on their municipal bond index rose from 13.88 yesterday to 14 percent in yesterday's papers. That's the average that they are applying across the country on municipal bond issues so it has gotten very high.

Senator **Byrd**. Well, Mr. Guthman, you say last fall you paid 9 percent.

Mr. **Guthman**. Over 9 percent.

Senator **Byrd**. Over 9 percent but you are now going to pay 14 percent.

Mr. **Guthman**. That was a relatively small issue sold on a general obligation basis. We received a favorable rate for the times because we entered the market when there was a good window. The bonds for the airport will be revenue bonds, which are always going to be slightly higher in rate than general obligation bonds. And, we may not decide to sell them because of the high rates. In fact, until the General Assembly of Georgia changes the laws, we cannot sell them. There is a usury limit of 12 percent in Georgia.

Senator **Byrd**. Well, I must say that I can't understand why there would be a spread of almost double, 5 percentage points.

Mr. **Guthman**. We are talking about two things that have taken place in that period of time, Senator. One was the timing of the sale of the bond and being able to take advantage of a 2-week window the market. The second was the fact that it was a relatively small issue of only $8 million. We also had very good credit rating and several good bids. Now we are talking about issuing close to $100 million in revenue bonds for an airport runway.

Senator **Byrd**. What would be the maturity on the $100 million bonds?

Mr. **Guthman**. We are looking at a 20-year total maturity.

Senator **Byrd**. Was the other 20 years also?

Mr. **Guthman**. Those were shorter. We went short on those bonds to be able to get a lower rate of interest.

Senator **Byrd**. Well, that would help you of course. Thank you. May I make this comment?

The **Chairman**. Sure.

Senator **Byrd**. I notice that on the next panel will be the Mayor of the city of Norfolk. I must meet right now with the members of the Virginia Farm Bureau. Mayor Vincent Thomas is listed as a member of the next panel. I don't know whether he is here or not. I don't see him at the moment. But I just wanted to say to the Committee that he is an outstanding Virginian. He's the Mayor of the largest city in our State. He is a very close personal friend. He is a graduate of the Virginia Military Institute. And if I am not here to welcome him, I hope, Senator Dole, that you would welcome him for me.

The **Chairman**. We will be very good to him.

Senator **Byrd**. Thank you. [Laughter.]

The **Chairman**. Senator Bradley.

Senator **Bradley**. Yes. I would like to ask Mr. Esser and Mr. Shapiro if you could clear up for me—what is your position on the minimum tax and why? I didn't get that.

Mr. **Esser**. Senator Bradley, we do not oppose the minimum income tax. We only have concerns with one of the 14 preference items that were recommended by the administration. It's the item which would deal with debt to carry tax-exempt bonds. Our concern is because commerical banks purchases of municipal bonds would be primarily affected by that particular item. Commerical banks currently hold about 45 percent of all tax-exempt bonds.

Both of the witnesses to my right have indicated the importance of short-term, tax-exempt bonds to their communities recently. Commercial banks, from our best calculations, hold about $15 to $20 billion of a $25 billion amount of outstanding short-term notes. Short-term note is one of the only ways many communities can finance needed facilities with these record high interest rates today. If commerical banks wanted to, they could simply leave the short-term tax-exempt market, and it would significantly increase our cost of borrowing.

Senator **Bradley**. And it's your view that banks don't do that. Why? Why don't banks leave the short-term market?

Mr. **Esser**. Well, currently they are purchasing short-term bonds because that is one of the few securities that are being offered by State and local governments. They do buy some tax-exempt bonds also.

Senator **Bradley**. No. But the tax advantage that this preference change addresses is specifically what? And you feel that if it was removed, it would adversely affect your municipal tax-exempt market, right?

Mr. **Esser**. Yes. We do.

Senator **Bradley**. Would you state that for the record a little more clearly?

Mr. **Esser**. Well, the minimum income tax item that you are referring to would remove the deductions that banks now have for the interest costs to purchase or carry tax-exempt bonds. And it would subject the cost of their interest that they now pay to a minimum income tax. That would, in our view, lessen their demand for tax-exempt bonds. Since they are so important in the market, once they have less demand for tax-exempt bonds, State and local governments would have to sell more bonds to individual purchasers and we would have to pay higher interest rates to attract more individuals to the market.

Senator **Bradley**. I would like to ask Mr. Shapiro this. In your comments, you said that you would not be in favor of eliminating the depreciation portion of ERTA in areas where you have industrial revenues bonds as well. You want a firm to be able to take advantage of both. Would you establish any other criteria or would you apply this to all firms everywhere? What would be a targeting criteria that you might establish?

Mr. **Shapiro**. Well, the administration has proposed an——

Senator **Bradley**. Well, cculd you give an example of how it would work in Essex County?

Mr. **Shapiro**. The administration has proposed an either/or setup. You have to choose either between ACRS or tax-exempt financing. What this would basically mean is that it would wipe out tax-exempt financing for most firms, because ACRS, in most cases, is a better choice for them to make.

What it means in an area like ours is that it would get rid of the locational advantage that is given by tax-exempt bonds. In New Jersey it is one of the States that does this. Senator Tsongas mentioned earlier that Massachusetts does this as well. In New Jersey we do have targeting provisions that are contained locally within the issuance of our tax-exempt bonds. What this would simply do is say basically that targeting mechanism would be wiped out. In effect, the one kind of incentive we have for investing in an urban area would get wiped out. And it would hurt an economically distressed area like our own obviously.

Senator **Bradley**. Because firms would opt for ACRS as opposed to IDB's. And, therefore, the targeting mechanism. Is that right?

Mr. **Shapiro**. They are saying either you get a big incentive to invest anywhere or you get a small incentive to invest in an urban area. If you have that choice, it means you are likely to not invest in an urban area.

Senator **Bradley**. Thank you very much.

The **Chairman**. Well, we have the enterpise zone program coming along to take care of that. It's not out yet.

Mr. **Shapiro**. We are eager to see that, Senator.

The **Chairman**. Yes. Mr. Shapiro, in the Congressional Record of March 28, 1968, former Senator Ribicoff quotes the National Association of Counties as stating that the use of private purpose bonds "poses a disastrous threat to the entire State and local government bond market, and that corrective action must be taken now." The other witnesses this morning seemed to be more in agreement with that statement made in 1968 than you, representing the National Association of Counties, do today. Don't private purpose still threaten the traditional State and local bond market? Why has NACO changed its mind?

Mr. **Shapiro**. Senator, our position is that some restrictions are in order. NACO's position is that some restrictions are in order, and that they do make sense. That others are not. That some of the ideas for basically eliminating them really don't make a lot of sense because here to have in NIRC——

The Chairman. We are not suggesting eliminating it, though apparently NACO thought that appropriate in 1968; we are just suggesting tightening it up so it will help small business, and so that it will be for some useful purpose, not just for any purpose. As Mr. Guthman said you can use it for almost any purpose now. We have seen the horror stories that I am not going to dwell on, but some will.

Mr. Shapiro. Senator, our belief is that the proposals as they are currently written would virtually wipe them out. And, second, that simply trying to make a differentiation between small business and big business doesn't recognize the important contribution that major businesses make. Simply trying to make a need differentiation between small business and big business doesn't recognize the important contribution that big investors make in certain economically distressed areas toward job creation. And really, in a lot of ways, this is what this is all about.

The Chairman. Senator Grassley.

Senator Grassley. Thank you, Mr. Chairman. I have only one question. And I hope even though you are connected with local government you still might be able to respond to local businessmen's attitudes toward competition with businesses that have tax-free revenue bonds. And I would like to ask whether or not you have had complaints from local business people trying to compete with larger franchises which have received tax-exempt bond help. And, therefore, cheaper credit to finance their new construction.

Mr. Shapiro. In our area, I have not heard that kind of complaint. In fact, the biggest single complaint I have gotten from small businesses—many of whom have benefited from this program—is that in some cases it can't go far enough. That they are interested in trying to get tax-exempt financing for things like working capital loans, which recently our State moved into being able to do. It can be a big help to small businesses. I don't think it is one where a small businessman will say only the big businesses are getting the advantage of it.

Mr. Guthman. In my city of Atlanta, we did have one such case last year that became the subject of testimony before the Ways and Means Committee of a hotel which is now just getting under construction. The hotel is not in a depressed area of our downtown and it was financed through industrial development bonds. The project did create some controversy not only here but locally, as well.

The Chairman. I guess you all indicate there should be some restriction on the use. Is that correct?

Mr. Guthman. Yes.

Mr. Shapiro. Yes.

Mr. Esser. Yes.

The Chairman. So it's fair to say you are in agreement on that. There is some disagreement on just what the restriction should be and to what extent you support the administration's proposals. My understanding is that Mr. Guthman and Mr. Esser have very little quarrel with the proposal. Is that correct?

Mr. Guthman. Where we take exception to the administration proposal, Mr. Chairman, is detailed in my formal statement, but I want to make sure you hear from me that we do oppose the bond registration requirement. In addition, we would like the provision that limits small issue IDB's to small businesses amended. In certain urban redevelopment areas in order to have a feasible project, it is frequently going to require a concern or a company whose total capital expenditures are going to be more than $20 million in a 6-year period. A large company is needed in many developments in order to attract others and to serve as an anchor. We would like to see the provision modified to account for that.

Mr. **Esser**. Senator, we do not fully agree with the administration's proposals. And we outline those concerns in our written statement. The one area we have the greatest difficulty with is the financial contribution on the part of the local government. Our research has found in a majority of the States that might be prohibited by either the State constitutions or State statutes. We think that recommendation is overkill. We feel the approval by local officials and local elected bodies would achieve the same thing that the contribution would, and that is necessary oversight at the local level.

The **Chairman**. Well, if we didn't adopt that provision maybe we would have to adopt some limit on the uses. It seems to me that if the local community is putting up even as little as 1 percent, they might be a little bit concerned on what the purpose is. Maybe we would have to look at some specific purposes.

I understand that none of the panel thinks we ought to include the tax-exempt income as part of the minimum tax proposal. Is that correct?

Mr. **Guthman**. Yes.

Mr. **Shapiro**. Yes.

Mr. **Esser**. Yes

The **Chairman**. That may not be what happens but—you think banks shouldn't pay taxes?

Mr. **Guthman**. No, sir.

The **Chairman**. They don't pay much now.

Mr. **Guthman**. We are not here to defend the banks. What we are here to say is that banks have been our best customers for tax-exempt bonds. Sometimes under adverse conditions they have purchased bonds when other investors were not willing to do so. Banks have told us, or at least I have been told in Atlanta, that if this preference item included in the minimum tax proposal, then they will substantially abandon the municipal market. And we will be hurt.

The **Chairman**. Your concern is they drive up the price.

Mr. **Guthman**. This will drive up the price as well as eliminate some of our best customers.

The **Chairman**. Well, there has been no decision made on the minimum tax. It's hard to get people who don't pay taxes to volunteer to pay taxes. Even those who pay taxes, but not very much. But it's also hard to explain to working men and women who pay a pretty good tax rate why some people should have tax-exempt income of a million dollars or more and pay no tax.

Mr. **Guthman**. In the long run, Senator, if our bond prices go up, then those same taxpayers are going to be paying for it through higher rates. And then we will have to charge more on general obligation bonds on our tax base. We will have to up our millage rate to accomplish that.

The **Chairman**. Well, we will try not to settle that issue here today. But I think it is good that you have indicated your opposition.

Senator **Bradley**. Mr. Chairman?

The **Chairman**. Yes.

Senator **Bradley**. This is the first time I have heard this assertion. Is there anyway that you could provide the committee with some more detailed backup from your financial officers as to its effect on the municipal bond market?

Mr. **Guthman**. Yes; NLC will certainly provide additional information, Senator.

Mr. **Esser**. Senator, we provided some figures in our written statement. We are now conducting an analysis and we will provide that to you as soon as possible.

Senator **Bradley**. I think that will be helpful.

[The information follows:]

AN ANALYSIS OF THE IMPACT OF THE PROPOSED CORPORATE MINIMUM INCOME TAX ON TAX-EXEMPT INTEREST RATES AND BORROWING COSTS

John E. Petersen
Government Finance Research Center
Municipal Finance Officers Association
March 1982

Under the recent Treasury proposals, a new section will be added to the current minimum tax provisions, imposing a new 15 percent alternative tax on corporate minimum taxable income in excess of $50,000.[1] The tax base will be a corporation's regular taxable income, increased by the sum of certain special deductions.

One revision in the corporate minimum tax base (Item #9) would be inclusion of interest on indebtedness used to purchase or carry tax-exempt securities (to the extent such interest is deducted under current law). The current rule of section 265(2) disallowing deduction of expenses and interest relating to tax-exempt income does not apply to commercial banks (or to other financial institutions having less than 15 percent of their total assets invested in the tax-exempt obligations). In determining the amount of interest deduction to be added to the minimum tax base, the corporation's total interest deductions would be allocated pro rata across its total investment portfolio. Thus, in effect, that share of interest cost now deductible against income taxes would be subject to the minimum tax of 15 percent. Because of their major holdings of tax-exempt securities and their low taxable profits on economic income because of the nonapplicability of section 265(2), commercial banks are the key target of the new minimum tax provision.

Impact on Bank Demand for Municipal Securities

The proposed change would greatly reduce the attractiveness of tax-exempt securities to commercial banks. Bank demand is crucial to the health of the municipal bond market. Because commercial banks, as the largest single investor group in such securities, hold about $155 billion, or 45 percent, of all outstanding municipal securities, any action that greatly weakens their demand for these credits will have severe adverse impacts on the tax-exempt securities market. Furthermore, bank demand can change rapidly. As of September 1981, commercial banks held an estimated $20 billion in short-term, tax-exempt securities (those due in less than one year), and probably another $10 to 15 billion in bonds maturing within a year. Thus, banks have the capacity to alter their portfolios rapidly to reflect the changing advantageousness of different security holdings.

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[1] See: Department of the Treasury, General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals, February 26, 1982.

At present, the pressure on the municipal bond market, relative to other credit markets, is particularly severe. As Table 1 depicts, the ratio of tax-exempt to taxable rates has risen sharply over the past year. Interest rates are high in all the securities markets, but nowhere has the increase been so abrupt and unrelenting. The practical consequence of this is that tax exemption has lost much of its cost-saving advantage to state and local government issuers. Major reasons for these poor conditions in the tax-exempt market are the impacts of recent tax code changes, recessionary conditions that have reduced profits and income, and credit concerns surrounding state and local issuers. Any step that further handicaps the tax-exempt securities market and raises borrowing costs must be viewed with concern.

A corporate minimum income tax that includes the pro-rata share of interest deductions on the presumption that the interest is used to carry tax-exempt securities would reduce the demand for tax-exempt securities by commercial banks. To measure the impact of this outcome on the tax-exempt market and the cost of borrowing to issuers requires answering three subquestions:

1. By how much will commercial bank demand for tax-exempt securities be reduced?

TABLE 1

BOND BUYER 20 BOND INDEX (TAX-EXEMPT), MOODYS ALL-INDUSTRY CORPORATE BONDS (TAXABLE), AND RATIO OF RATES:

1978 to 1982.I

Year/Quarter	Bond Buyer 20 Bond Index (Tax-Exempt)	Moody's All-Industry Corporate Bonds (Taxable)	Ratio Of Tax-Exempt To Taxable (%)
1978 (yr.)	6.07 %	9.07 %	66.9 %
1979 (yr.)	6.53	10.12	64.5
1980/I	8.56	12.80	66.9
1980/II	7.86	12.32	63.8
1980/III	8.79	12.30	71.5
1980/IV	9.61	13.67	70.3
1981/I	9.97	14.09	70.8
1981/II	10.68	14.89	71.7
1981/III	12.03	15.65	76.9
1981/IV	12.59	15.64	80.5
1982/I*	13.13	16.09	81.6

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* First two months data

2. What will be the impact of reduced bank demand on interest rates in the tax-exempt securities market?

3. How will the total cost of borrowing to states and localities change in response to the rise in tax-exempt interest rates?

Reduction in Commercial Bank Demand Caused by Minimum Tax

As is discussed in a separate appendix to this paper, it can be shown that under certain simplifying assumptions regarding profit-maximizing behavior, the optimum proportion of tax-exempt assets (those with tax-exempt income) to total assets can be estimated by the ratio of the average cost of interest and operations per dollar of assets to the average rate of return on taxable investments. If banks are maximizing their after-tax return, their portfolios should approximate the following composition of tax-exempt to total assets:

$$(E/A)^{*} = \frac{\text{Tax-Exempt Assets}}{\text{Total Assets}} = 1 - (r_c/r_t)$$

where,

r_c = average rate of total cost (interest and operating costs),

r_t = average rate of taxable return on assets,

$(E/A)^{*}$ = optimal proportion of tax-exempt assets to total assets.

Under the proposed change in the corporate minimum tax law, it can be deduced that the optimum ratio of tax-exempt to total assets would be determined by the expression:

$$(E/A)^{**} = \frac{\text{Tax-Exempt Assets}}{\text{Total Assets}} = 1 - Q$$

where, $$Q = \frac{(t - tm)\, r_c + tm\, r_i}{(t - tm)\, r_t + tm\, r_i}$$

where, r_c and r_t are as before, r_i is the average interest cost of funds borrowed, t is the normal corporate marginal tax rate, tm is the proposed minimum tax, and (E/A)** is the desired proportion of tax-exempt assets under the new minimum tax.

To the extent that banks are maximizing after-tax profits, it can be shown that the change will reduce bank holdings since

$$\frac{r_c}{r_t} < \frac{(t - tm)\, r_c + tm\, r_i}{(t - tm)\, r_t + tm\, r_i} .$$

Therefore,

$$1 - (r_c/r_t) > 1 - Q, \quad \text{and,} \quad (E/A)^* > (E/A)^{**}.$$

Thus, the optimal tax-exempt holdings are greater under the existing treatment than they would be under the corporate minimum tax. We can test the predictive quality of this formulation and examine the impacts of the proposed change by using actual values for the above variables to calculate predicted bank holdings of tax-exempt securities.

Table 2 presents a series of calculations that compare actual tax-exempt security holdings of commercial banks (E/A) for the period 1975 through 1980, with those predicted using the formula under the current tax treatment, (E/A)*, and under the proposed tax treatment, (E/A)**.[2/] As may be seen by comparing Columns 1 and 2, the predicted percentage holdings in tax exempts track the actual holdings very consistently and only slightly overestimate actual holdings during the period.

[2/] Column 1 figures for bank holdings and total financial assets are taken from the Federal Reserve Board, Flow of Funds Accounts, Assets, and Liabilities Outstanding 1957-80 (September 1981).

Column 2 is calculated using the formula $(E/A)^* = 1 - (r_c/r_t)$.

Column 3 is calculated using the formula:

$$(E/A)^{**} = 1 - \frac{(t - tm)\, r_c + tm\, r_i}{(t - tm)\, r_t + tm\, r_i} .$$

r_c, r_i, r_t are taken from the 1981 Annual Report of the Federal Deposit Insurance Corporation (FDIC). Also, $t = .46$ and $tm = .15$.

TABLE 2

Actual and Estimated Holdings of Tax-Exempt Securities as Percentages of Total Bank Financial Assets

	Column 1	Column 2	Column 3
	(E/A) Actual Tax-Exempt Securities As % Of Total Assets	(E/A)* Predicted T.E. Holdings Under Present Tax Treatment as % of Total Assets	(E/A)** Predicted T.E. Holdings Under Minimum Tax Proposal (15% note) As % Of Assets
1975	12.46 %	13.47 %	9.64 %
1976	11.90	12.26	8.93
1977	11.65	12.86	9.40
1978	11.17	13.23	9.73
1979	10.80	11.91	8.62
1980	10.76	10.21	7.27
Avg.	11.46 %	12.32 %	8.93 %

Note: The predicted percentages of tax-exempt holdings in Column 2 are, on average, slightly greater than the actual percentage holdings in Column 1. The proposed change would lower the predicted holdings (Column 3) of tax exempts. Assuming that actual tax-exempt securities would retain their proportionate relationship to the predicted levels implies that actual holdings of tax exempts as a percentage of total bank assets would drop as follows:

$$\frac{11.46}{12.32} = \frac{x}{8.93}\ , x = 8.31\%$$

Thus, the actual holdings are projected to drop by 3.15 percentage points (11.46 - 8.31) or by 27.5% (3.15/11.46) based on the 6-year experience reported above.

Column 3 gives the predicted percentage of assets in tax exempts, had the proposed minimum tax on allocated interest deductions (at a 15 percent rate) been in effect. It, too, tracks nicely the figures in the previous two columns, but at a uniformly lower level. On average, as indicated in Table 2, it would have produced a desired ratio of tax-exempt to total assets 3.15 percentage points lower than that actually observed, if we were to assume that actual holdings were to behave proportionately under the proposed tax treatment as they have to the existing tax treatment of nonallocation of interest costs. This would have meant a 27.5 percent drop in the optimal level of bank holdings, were the banks' respective average rates of overall costs (r_c), borrowing costs (r_i), and taxable investment earnings (r_t) to have been in effect.

To calculate the dollar magnitude of the 27.5 percent decline in tax-exempt holdings, we need to take this change in ratio to the dollar amount bank holdings as of the end of 1982. Since these were $155 billion, the estimated new holdings would be $112 billion. Other realistic estimates of the size of the reduction in holdings are possible, but do not differ greatly in magnitude given the facts and formulations as set out above.[3/] Such a reduction — approximately $43 billion — in bank holdings would be of enormous consequence. That amount represents almost the equivalent of one year's

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[3/] Alternative interpretations of adjustment from the current level of desired tax-exempt holdings are possible. For example, it is estimated that tax-exempt securities represented 10.3 percent of bank assets at the end of 1981. Assuming that this represented 95 percent of the desired ratio (as in 1980) under the current treatment and that, under the proposed changes, the new desired ratio would be about 71 percent of the former, the new desired ratio would be about 6.9 percent in tax exempts. This would represent a 3.4 percentage point (or 33 percent) decline in the desired holdings of tax exempts. Since banks hold $155 billion in tax-exempt securities, the 33 percent decline would mean a $51 billion decline in desired holdings to a level of $104 billion.

entire new offerings of long-term debt and approximates almost twice the size of recent net increases in tax-exempt debt outstanding.

Impact of Reduced Bank Demand on Tax-Exempt Interest Rates

The second issue to be resolved is to estimate the effect of banks' reducing their holdings of municipal bonds on tax-exempt interest rates and the activity of the tax-exempt securities market in general. A useful starting point is to consider the "surplus" of $43 billion in bank-held, tax-exempt debt as an increment in supply to be absorbed elsewhere in the market. Prior research has estimated that each billion in new supply of tax-exempt debt (holding other factors constant) increases tax-exempt rates by 3 to 5 basis points.[4/] Thus, $43 billion in "unwanted" municipals might be expected to increase tax-exempt rates on the order of 120 to 200 basis points (using 20-year bond yields as the index), with 160 basis points providing a mid-point estimate. The final observed effect would depend on many factors, including the sensitivity of new offerings to the upward surge in interest rates (elasticity of supply of new debt) and the speed with which banks would seek to achieve their new desired level of holdings.

On the latter point, it should be noted that banks hold relatively short maturities, dominating the tax-exempt note market and having a large volume of long-term bonds maturing each year.

In an attempt to shed more light on the impact of the change in bank holdings on tax-exempt rates, several statistical estimates were used to derive direct evidence. The general approach is to explain the level of tax-

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[4/] For a review of recent studies regarding the interest rate effects of incremental supplies of tax-exempt bonds, see Ronald Forbes, et al., "An Analysis of Tax-Exempt Mortgage Revenue Bonds," Municipal Study Group, State University of New York at Albany (May 1979) Appendix III.

exempt rates in relationship to taxable security rates by the composition of asset holdings by major investor groups and the total volume of tax-exempt securities outstanding in relation to total privately held credit market instruments in the economy.[5] Specifically, we can test if there is any statistical relationship between the ratio of tax-exempt to taxable rates, shares of tax-exempt securities in investor portfolios, and the amount of tax exempts outstanding relative to total credit in the economy. In order to minimize certain estimation problems and to focus on changes in the key variables, statistical regressions were estimated in first-difference form. Annual data were used for the period 1960 through 1981.

In Equation 1 in Table 3, the change in the ratio of rates, (RE/RT)', is a function of the change in the percentage of bank financial assets in municipal securities, (MSbc/FAbc)', and the change in municipal securities as a percentage of total credit market instruments in the economy, (MS/CMI)', where the prime (') indicates a change in the ratio. As expected, the ratio of rates is negatively related to increases in the percentage of bank assets in tax-exempt securities. It is positively related to the total amount of tax-exempt debt as a percentage of credit market instruments (but the relationship is not statistically significant). The constant in the first-difference formulation is equivalent to a positive time-trend in the ratio which is not attributable to the portfolio variables also found in the equation.

Equation 2 is a similar formulation, but one which seeks to explain further changes in the ratio of rates by taking into account the changing portfolio composition of the two other major investors in tax exempts, property and casualty insurance companies, and households (MSpc/FApc) and (MChh/CMhh),

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[5] The financial asset data used are from the Federal Reserve Board, Flow of Funds Accounts. The rates used are those defined in Table 1 above.

Equation 1

TABLE 3

Dependent Variable: (RE/RT)'

Independent Variables	Coefficient	Standard Error
Constant	.0051	—
(MS/CMI)'	.0362	.0516
(MScb/FAcb)'	- .0333	.0167

R^2 = .1920

standard error = .0395

period = 1960 to 1981 (annual)

(/)' = change in ratio in percentage points

Equation 2

Dependent Variable: (RE/RT)'

Independent Variables	Coefficient	Standard Error
Constant	.0137	—
(MS/CMI)'	.0284	.0556
(MShh/CMhh)'	.0092	.0106
(MScb/FAcb)'	- .0343	.0170
(MSpc/FApc)'	- .0100	.0036

R^2 = .5568

standard error = .0309

period = 1960 to 1981

(/)' = change in ratio in percentage points

Equation 3

TABLE 3 (Continued)

Dependent Variable: (RE/RT)

Independent Variable	Coefficient	Standard Error
Constant	.4562	—
(MS/CMI)'	.0500	.0430
(MShh/CMhh)'	.0136	.0083
(MScb/FAcb)'	- .0215	.0135
(MSpc/FApc)'	- .0077	.0029
$(RE/RT)_{t-1}$	.3727	.0430

R^2 = .6706

standard error = .0237

period = 1960 - 1981

(/)' = change in ratio in percentage points respectively). Explicit treatment of the other investors' portfolios improves the explanatory power (and agrees with expectations) but does not change to any degree the incremental effects of changes in bank holdings as found in Equation 1.

The results indicate that a one percentage point change in the percentage of bank assets in municipal securities will generate approximately a 3 percentage point change in the ratio of tax-exempt to taxable rates. Thus, were the ratio at .70 (approximately the average for the period), a one percentage point decrease in the proportion of bank assets in tax exempts would increase the ratio to approximately .73.

Equation 3 provides a slightly different formulation, whereby the ratio of rates itself is made a function of changes in asset composition, changes in the overall supply of tax exempts to total credit market instruments, and the previous year's ratio. This essentially argues that the ratio of rates this year is a function of last year's rate and changes in total relative supply and investor portfolios. Under this lag formulation, it can be assumed that there is a period of "adjustment" in the ratio to new levels as portfolios undergo change. The results imply that the first year's adjustment in the ratio would be .021 (2.1 percentage points) in response to a one percentage point change in bank portfolios. The final effect (long-term equilibrium) would be approximately a 3.4 percentage point change in the ratio, other things being constant.[6/]

The above statistical results can be coupled to the previous estimates of changes in bank holdings to estimate the impact of bank withdrawl from the tax-exempt market on tax-exempt interest rates. As a result of the

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[6/] $-.0343 = -.0215/(1 - .3727)$

minimum tax, bank holdings of tax exempts would shift down by approximately 3 percentage points. At 3.33 percentage points increase in the ratio per percentage point decrease in bank holdings of tax-exempts as a percentage of financial assets, this means a total upward shift of approximately 10 percentage points in the ratio of rates (3 x 3.33). At current long-term interest rate levels (see Table 1) and assuming the taxable rate remained fixed at 16 percent, this would result in an increase of approximately 160 basis points in tax-exempt interest rates ($RE' = (RE/RT)' \times \overline{RT}$).

Both on the basis of previous analysis and the statistical results used in this analysis, a 160 basis-point increase in tax-exempt interest rates appears to be a reasonable mid-point estimate of the likely impact of imposing the minimum tax as it relates to tax-exempt securities.

Increased Cost of Borrowing

The overall impact of the increases in tax-exempt interest rates on the borrowing costs of issuers will depend on the volume of tax-exempt securities that are sold. Recently, total reported new issue sales have been in the vicinity of $80 billion a year ($50 billion long-term and $30 billion short term). If we use the mid-point estimate of 160 basis-point increase in tax-exempt rates, this would translate into $1.28 billion in added borrowing costs for the first year. Since the long-term bonds will be outstanding for many years (say, 10 years on average), the total added cost of borrowing would be much greater during the period the bonds were outstanding.[7/]

[7/] If we assume $50 billion in long-term borrowing (with an average 10-year life on new debt) and $30 billion in short-term debt issuance, then the present value of the added lifetime cost of the first year's borrowings would be, discounted at 12 percent, approximately $5.5 billion.

There are, of course, numerous caveats that can be made in interpreting these results. For example, issuers may choose not to sell as much debt in the face of high interest rates (but there is, in that case, an opportunity cost in terms of foregone public improvements); future tax-exempt rates may not go up by as much as the past would imply as alternative markets are developed (but the overwhelming importance of bank demand to the tax-exempt market argues against that); many uses of tax exempts are not truly "public" in that they finance private activities (but that is a separate question relating to the propriety of certain present uses of Federal tax exemption).

It is true that not all of the added costs would be borne by governmental taxpayers and rate payers. While precise data are lacking, it would appear that, of regularly reported tax-exempt issues, approximately 25 to 35 percent of tax-exempt borrowing ($14 to $19 billion) represents aid to private business, homeowners, and non-public hospitals.[8/] But even lowering the total borrowing cost impacts to two-thirds of those described above (the interest rate impacts remain the same since they depend on the total supply of tax-exempts, not just those offered by governments), still leaves an added annual interest cost burden of $850 million per year that must be met by increased taxes and charges.

This added $850 million in state and local borrowing costs should be weighed against the added $144 million that the Treasury evidently plans by 1984 to obtain from banks by imposition of the new corporate minimum tax

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[8/] This does not include approximately $8 billion (of an estimated total of $10.5 billion) small-issue industrial development bonds that are not counted in nationally reported borrowing figures.

provisions.[9] Were almost all of the $144 million revenue increases attributable to taxing the interest deduction preference item, the ratio of increased borrowing costs for state and local governments to added revenues to the U.S. Treasury would be on the order of 5.9 to 1.[10] In other words, for every dollar in added Federal tax receipts, state and local governments would need to increase their taxes, fees, and charges by $5.90. The inefficiency and inequity of such a solution to the Federal budgetary gap — not only passing it on for states and localities to close, but multiplying it nearly 6 times in the process — are both remarkable and depressing.

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[9] According to the information released by the Treasury Department on February 26, 1982, the minimum income tax proposal would be expected to produce additional federal revenue of $4.8 billion in 1984. This, added to the current minimum income tax collections, would produce a total of $5.3 billion in that same year. The Treasury Department estimates that 2.9 percent of the minimum income tax will be collected from banking institutions, or approximately $153 million in 1984. At present, banks pay only about $9 million in minimum income taxes. Thus, the proposed changes would increase collections by $144 million.

[10] To the extent that other tax-preference items of banks account for the added revenues, the ratio of increased borrowing costs added receipts would be proportionately higher.

The CHAIRMAN. I think there is a classic argument as to whether the taxpayers in Kansas should pay for that fourth runway in Atlanta. Maybe a user fee would be more appropriate. If, in fact, you are going to push it off on the taxpayer nationwide, then I think that is an area we ought to focus on. Not that it means we ought to eliminate the program; just tighten it up considerably and which I think all of you agree is a good idea.

Mr. SHAPIRO. Absolutely.

The CHAIRMAN. Thank you very much.

Our next panel will be Councilman Bernardo Eureste on behalf of Mayor Henry Cisneros of the city of San Antonio, Tex., and the Honorable Vincent Thomas, the mayor of Norfolk.

Mr. MISTER. Mr. Chairman, it's clear that I am not Vincent Thomas.

The CHAIRMAN. It's not clear to me. I don't know Mayor Thomas. [Laughter.]

Mr. MISTER. But my name is Melvin Mister. I'm the deputy director of the U.S. Conference of Mayors. Mayor Thomas, is at another hearing in the Congress. And I am here to present a statement on his behalf for the U.S. Conference of Mayors.

The CHAIRMAN. We have seven witnesses following this panel so if you can summarize your testimony, your entire statement will be made a part of the record. And if there are questions then we will have some time for questions.

Do you want to be first, Mr. Eureste?

Mr. EURESTE. May I start now?

The CHAIRMAN. Yes.

STATEMENT OF COUNCILMAN BERNARDO EURESTE, ON BEHALF OF MAYOR HENRY CISNEROS OF THE CITY OF SAN ANTONIO, TEX.

Mr. EURESTE. Thank you very much, Mr. Chairman. My name is Bernardo Eureste. I am a member of the city council of the city of San Antonio. I am here on behalf of the mayor of the city, Dr. Henry Cisneros. I have been on that council for now going on 5 years. I am on my third term as a council member. And I am at a level of government that is very close to people, to where people are actually doing things, fixing streets, dealing with the entire structure of the community.

We have a statement that was presented to the committee. And that statement would stand for the record. And I would not like to read it.

I would like to, however, say that I have heard this morning some of the comments that were made. My profession is social work. I am an associate professor of social work, and have been teaching social work for the past 10 years. In my profession, I guess I would have to fall on the very liberal side of the profession. I deal with community organizing, and the issues of redeveloping communities.

I think if you deal with people in San Antonio and where they work—if they happen to work with a Fortune 500 or a Fortune 1000 corporation in the inner city, or if they are working for a small industrial company or commercial company in the inner city that that worker would be very content that he has a job. That he is not a burden on the society. That he is not having to go to the welfare office or to the unemployment office for benefits. The question of revenue that is foregone to the Federal Government because IDB's are tax-exempt does not take into considerable—or maybe it does—but doesn't seriously take into consideration the personal income taxes that workers that are employed in new jobs that are created because of IDB's. Those income taxes and in the lifetime would surely outdo the loss in Federal revenues from this corporation.

We did some real fast calculations over the past week on the benefits, cost and benefit, to the government. And in our calculations, the benefits outweigh the cost to the government by factors of 10 to 1; 20 to 1. And I think that we, in San Antonio, would much better attempt to do things in the inner city that would create opportunity for people rather than to have the decaying old city with the old streets and the old inner structures and the old buildings just sit there rotting away.

There is a question about the traditional role of municipal government. That traditional role is no longer limited to replacing cobblestone. We are in there providing fire protection, police protection, constructing and maintaining residential streets and urban transportation systems, constructing and maintaining waste water treatment systems, water gathering and distribution systems, gas and electrical systems, library systems, emergency medical services, drainage systems, housing programs and urban renewal and urban redevelopment need of the community.

I say that rather than sit here and argue that these bonds compete with the municipal bond market, I would say that they are a part of the municipal bond market. The role of municipal government today is very different than what it was in the 1800's. It is very different than what it was in the early 1900's. It has changed drastically.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Eureste follows:]

TESTIMONY BY COUNCILMAN BERNARDO EURESTE ON BEHALF OF MAYOR HENRY CISNEROS, OF THE CITY OF SAN ANTONIO, TEXAS, BEFORE THE SENATE FINANCE COMMITTEE IN CONNECTION WITH HEARING ON ADMINISTRATION TAX PROPOSALS

Wednesday, March 17, 1982

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear this morning on behalf of Mayor Henry Cisneros of the City of San Antonio, Texas, to testify on the importance of industrial development bond financing to the City of San Antonio.

San Antonio, Texas is the 11th largest city in the nation with a 1980 population in excess of 800,000. Over one half of the residents of the City are members of an ethnic minority with approximately 53% being of Hispanic ancestry. Historically, the industrial base of the City has been limited, providing low-paying, low-skill jobs in labor intensive enterprises with very little opportunity for upward mobility. At the same time, the central business district of the City has deteriorated, leaving prominent structures of historical and architectural significance to experience decay and disuse.

Recently, however, San Antonio, its leaders and its people have begun to march out of this economic and cultural malaise toward a new San Antonio, offering a diversified industrial base with opportunities for developing skills, for earning higher pay and for upward mobility, while building a revitalized downtown which preserves the beauty of the past for the excitement of the future. While we have not yet attained our goal, we are intent upon improving the situation of our citizens and realizing a place of prominence for our City.

Quite frankly, we need assistance in attaining our goal. The disappointing experience of having a major high technology complex cancelled due to exorbitant borrowing costs is all too real for us. Accordingly, our City has established an Industrial Development Authority to provide tax exempt borrowing at reduced interest rates for new industrial facilities locating in our City and for commercial projects which revitalize and preserve our downtown area. While industrial development bond financing is only one aspect of a complete program of economic assistance that is administered by the City's Department of Employment and Economic Development (DEED), it is an essential linchpin in our efforts to encourage industrial growth and downtown redevelopment.

It is important to stress the involvement of the City government in the industrial development bond program. In San Antonio, industrial development bond financing is the City's program. The Board of Directors of the City's Industrial Development Authority is comprised of 11 members appointed by the City Council and representing a wide variety of community interests. Following approval by this Board, each project must also be approved by the full City Council at a public meeting. Therefore, the Authority is not an uninvolved group that operates outside of the purview of elected City officials, but rather is an integral part of the mechanism created by the City to effectuate its responsibilities toward its citizens.

In addition to the City's review, Texas law requires every financing to be studied and approved by a State agency; only those projects that satisfy the rather stringent standards of the agency's rules will be approved.

A major goal of the City has been the revitalization and redevelopment of its historic, downtown area. Few cities have the rich heritage of architecture enjoyed by San Antonio, but because of the age of the City, many of its historic buildings are subject to rapid deterioration. Since Texas approved its IDB program in 1979, private business interests have been induced to restore several historic downtown buildings because of the availability of tax exempt financing. Many of these projects would not have been economically feasible at today's high interest rates without the reduced borrowing costs provided by industrial development bond financing. Because local lending institutions and private developers have shown faith in the community and have been willing to undertake downtown redevelopment projects financed with industrial development bonds, the face of downtown San Antonio is changing.

We recognize that there have been abuses in industrial development bond financing and we concur with the recommendation that all financing should be subject to the sort of scrutiny by public officials or their appointees at both the local and the state level that we have in Texas. We believe, however, that many of the recent proposals of the Administration will penalize a city in need like San Antonio by depriving it of a vital aspect of its plans for tomorrow. For example, denying large and medium sized businesses industrial development bond financing is totally inconsistent with our city's overall plan to diversify its industrial base. We know that the large and medium sized businesses provide permanent employment and serve as a magnet for attracting other firms. Also, we object to the Administration's proposed $20,000,000 limit on worldwide capital expenditures. Our City is attempting to attract, among others, high technology firms which must make significant capital investments in research, development and equipment to remain competitive. The Administration's proposed limitation effectively means that this sort of industry will no longer have the alternative of industrial development bond financing and San Antonio may no longer have the opportunity to serve as a home for such industry.

In conclusion, our City would encourage some reform of the industrial development bond privilege to assure that it is in furtherance of achieving the public purpose of healthy industrial growth and revitalization. However, we believe that many of the proposals set forth by the Administration are so stringent in nature as to be intended to discourage or prevent a business from utilizing industrial development bond financing.

If ever there was a time in the history of our City (if not our country) when we should be encouraging businesses to borrow money and make capital investments it is now. To deny business the reduced borrowing costs afforded by industrial development bond financing during this time of unimaginably high interest rates is to frustrate our City's plans to revitalize its downtown and to provide its citizens with opportunity for upward mobility. We respectfully request this distinguished Committee not to recommend legislation which will deny our City the use of this important tool for industrial growth and redevelopment.

STATEMENT OF MELVIN MISTER, ON BEHALF OF HON. VINCENT THOMAS, MAYOR, CITY OF NORFOLK, VA.

Mr. MISTER. The Conference of Mayors, as you know, is an organization of cities over 30,000 in population. Mayor Thomas couldn't be here for this hearing. He is somewhere else in the Congress testifying as the chairman of our committee on economic development. He is, as Senator Byrd said, a very knowledgeable person about the subject of this hearing, and has done a terrific job in the city of Norfolk. He wishes that he were here.

I would like to very quickly summarize our specific comments on the items in the administration's proposal which are detailed tc a greater extent in our statement.

First of all, on the minimum tax proposal, Mr. Esser, I think, stated quite well the views of the Conference of Mayors on the minimum tax proposal. We don't want to take a position on the question of whether or not there ought to be a minimum tax, but the preference item that relates to tax-exempt issuance is something that we oppose. We hope that the Congress would not approve that aspect of the minimum tax.

Second, on the industrial revenue bond issue, we think these bonds are very sound items for economic development. They've become an important part of local government activities in our major cities, and we hope the program will continue. We do, however, agree that some restrictions are necessary and are in order. We are concerned about the pressure that IDB's place on the borrowing costs of local government.

There are a number, of what we have been calling, good government changes that would be in order. We think that if they were approved, it would relieve some of the pressure on the municipal bond market. Approval would result in some limitations in the use of industrial revenue bonds for purely private purposes. These changes include local approval by governing authorities, better reporting requirements and other items which we have spelled out more in our testimony.

A second item on IDB's is the question of straight line depreciation or accelerated cost recovery. Our concern is one which revolves around certain kinds of activities which local governments are clearly sponsoring that might be made difficult or impossible by the approval of the administration's proposal. For example, a number of cities are getting involved in resource recovery activities where private companies are constructing facilities or doing things to turn trash into some useful purpose. Those kinds of public-private relationships are extremely important. Legislative language should be drafted which would permit these kinds of activities to continue, and we would like to work with the committee on that.

A third item with respect to IDB's has to do with the question of limiting the size of the businesses that can benefit from IDB's. We think that with the kind of good government changes outlined earlier, this problem can and should be dealt with at the local government level. We resist the idea of the national limitation, and would rather see the issue handled through local government approvals of industrial revenue bonds.

I would like to mention two or three other items in the administration's proposal that are of concern to us. One of them is the 1 percent local commitment of money to help finance a project. We think that this provision, if it were approved, would penalize those cities that are most distressed and have the most difficulty coming up with those dollars. We hope that Congress will not approve this provision.

A last item I would like to mention has to do with the administration's proposal to repeal the energy tax credits. Despite the oil glut that many people talk about now, we feel that this is not the time to remove incentives for energy conservation. The Conference of Mayors has a longstanding policy about greater independence in the energy area in this country, and we don't think that because we have a glut now we should remove those. It would be premature to remove those energy tax credits.

That's the conclusion of my summary, Mr. Chairman.

[The prepared statement of Mr. Mister follows:]

UNITED STATES CONFERENCE OF MAYORS
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TESTIMONY OF

MELVIN MISTER
DEPUTY DIRECTOR
U.S. CONFERENCE OF MAYORS

before the

SENATE FINANCE COMMITTEE

March 17, 1982

Mr. Chairman, Members of the Finance Committee, thank you for this opportunity to testify today on industrial revenue bonds and the other tax proposals of the Administration for FY83.

First, the Conference of Mayors is deeply concerned about one feature of the minimum tax proposal of the Administration. One of the tax preference items to which the minimum tax would apply is the deduction for debt used to buy or carry tax exempt securities. The impact of this proposal on the state and local bond market has not been fully analyzed by the Treasury Department. According to a preliminary study of the Municipal Finance Officers Association, the cost to state and local governments will total over $1 billion -- hardly an insignificant amount. We are concerned that such a proposal will wreak further havoc on the municipal bond market, already reeling from the effects of high interest rates, federal and state budget cutbacks, declining municipal credit ratings, the effects of last year's tax law, federal limitations on state and local bonds, and the general uncertainty currently prevailing in the market.

Banks are the largest holder of state and local bonds, especially short-term securities, and to the extent they must pay taxes on debt used to carry such bonds, they will have less incentive to purchase our securities. The result is likely to be an unprecented dumping of our bonds and much higher interest and borrowing costs for cities.

Given the immense infrastructure needs of local governments for highways, bridges, sewer and water systems, it is important that we have the continued support of the banks and other inventory in order to obtain the huge sums of capital needed to finance these public projects in the years ahead.

Secondly, we are concerned about some of the Administration's proposals to restrict the issuance of small issue industrial revenue bonds. Small issue industrial revenue bonds are an important economic development tool for central cities, helping to attract new firms and to create job opportunities. We believe this important development tool should remain available to local government. We do support, however, proposals to require approval of IDBs by the highest elected official or legislative body of the jurisdiction in which the facility is located, public hearings and reasonable reporting requirements. These "good government" changes are overdue and will keep some control over the growing volume of IDBs.

The Conference of Mayors is concerned about some of the Administration's other proposals. As you know, the Administration recommends that private assets financed with tax-exempt IDBs must be depreciated under the straight line method, rather than under the accelerated depreciation method (ACRS) permitted under the new tax law. The Conference of Mayors is concerned that this option will result in the cancellation or bankruptcy of many important projects in cities, such as resource recovery and solid waste projects. Such projects are often losing or marginal enterprises during their early years and need both types of subsidies. We urge this Committee and the Congress to consider possible exceptions to the Administration's proposal and to analyze fully the efforts of this proposed restriction on important municipal and private undertakings.

In addition, we are opposed to the very tight limits proposed on the size of businesses which can benefit from small issue IDBs. The $20 million capital expenditure limitation will prevent many central cities from using IDBs to attract private industry and create manufacturing jobs. This is an important and justifiable economic development objective of many cities.

Finally, we are concerned about one other Treasury proposal - the requirement of a one percent local commitment. While the one percent local contribution is not required until January 1, 1986, the Conference of Mayors is troubled that such a requirement will have the perverse effect of penalizing those distressed cities and areas that most need the benefits of IDBs, since it is likely to be easier for a wealthy community to generate the financial commitment than for a poorer heavily taxed jurisdiction. We urge this Committee to waive this provision for distressed communities until 1986.

Finally, we also have some reservations about the Treasury Department's restricting earnings on reserve funds and funds held during the construction period. To the extent this provision interferes with public projects undertaken by cities, we are opposed to its implementation.

One final point with respect to the President's tax proposals. The repeal of business energy tax credits, as proposed by the Administration seems to us to be short-sighted. Although the energy crisis is no longer of immediate concern, nevertheless we believe the federal government should continue to encourage energy conservation. We are particularly distressed at the proposed repeal of the tax provisions which allow local governments to issue tax-exempt bonds for solid waste and similar energy facilities.

Mr. Chairman, in summary, the Conference of Mayors is concerned about the imposition of the proposed minimum tax on debt used to purchase state and local bonds, some of the proposed restrictions on industrial revenue bonds, and the repeal of tax provisions which encourage energy conservation.

Thank you for this opportunity to testify on the President's proposed tax changes. We look forward to working with you to design a tax bill which meets the important needs of our urban areas and our low- and middle-income taxpayers.

The CHAIRMAN. Senator Grassley. [No response.]

I don't have any questions, but I want to thank you both for your testimony. And, again, we will certainly consider the points you made, and the additional points made in your written statements. I know you didn't have time to present the entire statement.

Some municipalities now contribute 1 percent or more by property tax abatement or some other provision. It would seem to me that 1 percent would not be asking a great deal as far as a local effort is concerned. But it is an area that is controversial. It is one that the administration feels strongly about. As far as the energy credits are concerned, we will be having testimony on that particular matter, I think, Friday afternoon. And we will make certain that your statement with reference to energy credit also appears in the hearing Friday.

Mr. MISTER. Thank you very much, Mr. Chairman.

Mr. EURESTE. Mr. Chairman, may I leave this with your staff? This goals for economic development for the city of San Antonio?

The CHAIRMAN. Yes. We would be pleased to have it.

Mr. EURESTE. Thank you.

The CHAIRMAN. Our next panel is Mr. Bruce Thompson, Health Care Fund, Lima, Ohio; George C. Phillips, Jr., acting chairman, Council of State Hospital Authorities, Washington, D.C.

STATEMENT OF BRUCE THOMPSON, HEALTH CARE FUND, LIMA, OHIO

Mr. THOMPSON. Mr. Chairman, members of the committee, my name is Bruce Thompson. I'm president of the Health Care Fund. We are a real estate investment trust whose primary business is the financing of nursing homes for operation by small family units—the so-called "moms and pops".

The CHAIRMAN. Before you begin, I note that Mr. Thompson's colleague is Senator Taft. It is nice to have him here. I am afraid I am unacquainted with the gentleman in the middle.

Mr. PHILLIPS. The gentleman in the middle, Mr. Chairman, is Mr. Douglas Mitchell who is the executive director of the Colorado Health Facilities Authority, a member of the Council of State Hospital Finance Authorities.

The CHAIRMAN. Again, if you could summarize your statements, it would be helpful. The entire statements will be made a part of the record.

Mr. THOMPSON. All right, sir. My particular interest is on the nursing home side so I will focus on that.

Our company, as I said, has been in the business of financing nursing homes for the last 10 years. Without tax-exempt IDB's, the Health Care Fund could not have constructed and financed 22 nursing homes over the last 4 years. There are presently employed in these homes approximately 1,800 people, 90 percent of whom are in the semiskilled or unskilled entry level categories.

The availability of tax-exempt financing, in other words, is the only source that enabled us to continue during the last 4 or 5 years when banks and savings and loan associations were not in a position to advance the debt money needed to build nursing homes.

And it has the advantage of holding down occupancy costs which have to be reimbursed under medicare and medicaid programs.

To give you an order of magnitude for the bed need situation nationwide, according to census figures which we have interpreted, we feel there will be a need for 400,000 nursing home beds in the next 20 years—new beds in new facilities. At the constant 1982 cost of $20,000 per bed, we are talking about $8 billion worth of nursing home development which will have to be financed in the next 20 years, or $400,000 per year on the average.

I have been instrumental in the adaptation of IDB's to this type of financing. All of our revenue bonds are issued publicly through underwriters. We do not sell them to banks in private transactions. Our projects and financing programs are discussed twice, three times and sometimes four at public hearings before the appropriate authority of the county or State or city. I continue to participate in these public hearings until our applications are either rejected by the authority or we are accepted and inducement resolutions are given.

I am not familiar with any technique whereby inducement resolutions can be achieved without the knowledge and full participation of the local public authorities. We have been involved in a public hearing and in two or three or four visits every time.

I wish to state that the very same authority which sets priorities on infrastructure and other public improvements, such as roads, school districts, and water systems—those are the same people who find that our nursing home developments have a place on the priority list and should be given a chance at tax-exempt revenue bond financing.

We think that the financial markets will be choppy for some time to come. I am personally convinced that the savings and loan associations, which in the early 1970's were a source of nursing home finance, will not be open to us, at least not in the foreseeable future. I'am also convinced that commercial banks cannot go out the length of time that is required to finance a nursing home. A nursing home project has a payback period of 15 or 20 years, not 5 years. We cannot possibly borrow money on a 5-year basis on the slim hope that we can refinance the debt at the end of the 5-year period. That is just taking too much of a risk.

Our system is to lease these buildings to small family units. We have 50 of them out on long term leases. About 22 of them were built with IDB's over the last 4 years. We offer these operators, the small family units, an option to buy the buildings so that they can end up with them as their own property after 5 or 10 years.

Without IDB's, our system of lending expertise and credit to family operators during the critical startup years would be seriously threatened. If we are put out of business, I think the nursing home industry will suffer. Actually, what would happen is large chains with access to Wall Street money would build branch stores to fill the bed needs instead of the "moms and pops" who now predominate in the industry. I don't have the exact statistic, but I believe 80 percent of the nursing homes in the country are run by independent family units. And I have that's the way it should stay.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Thompson follows:]

STATEMENT OF

BRUCE G. THOMPSON, PRESIDENT, CHAIRMAN AND
CHIEF EXECUTIVE OFFICER, HEALTH
CARE FUND, LIMA, OHIO

RELATING TO

PROPOSED RESTRICTIONS ON TAX-EXEMPT
BONDS FOR PRIVATE ACTIVITIES

BEFORE THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

MARCH 17, 1982

SUMMARY OF PRINCIPAL POINTS

STATEMENT OF BRUCE G. THOMPSON
PRESIDENT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER
HEALTH CARE FUND, LIMA, OHIO

Without tax-exempt financing, Health Care Fund could not have constructed approximately 22 nursing home facilities at which there are presently employed approximately 1,760 individuals, 90% of whom are in the semi-skilled or unskilled category.

Tax-exempt industrial development bond financing has permitted Health Care Fund to grow, with the attendant public benefits of job creation, improved health care, and greater Federal, state, and local revenues, even in an extremely adverse economic climate.

This is not simply a question of allowing Health Care Fund to enjoy greater profits. Without the availability of tax-exempt industrial development bond financing, Health Care Fund's operations would have stagnated in the present economic environment, hundreds of present and secure permanent jobs would not exist, and hundreds of thousands of dollars of revenue at the state, local, and Federal levels would have been lost.

The industrial development bond program is neither a nicety nor a luxury--rather it is indispensable to our ability to provide the critical health care services which we undertake.

TESTIMONY OF MR. BRUCE G. THOMPSON
OF HEALTH CARE FUND

Mr. Chairman, my name is Bruce G. Thompson. I am President, Chairman and Chief Executive Officer of Health Care Fund, the principal office of which is located in Lima, Ohio. I appreciate the opportunity to appear before this Committee and to describe for it the essential role industrial development bond financing has played in the growth and development of Health Care Fund.

Health Care Fund is in the business of owning, and leasing nursing homes to small family owned operators in a five-state area consisting of Ohio, Indiana, West Virginia, Missouri and Pennsylvania. At present, our portfolio of nursing homes numbers forty-eight facilities, of which twenty-two were financed in whole or in part with industrial development bond issues. Many of these facilities were financed within the last few years at a time when the conventional mortgage money windows had been slammed shut. Thus, without the availability of tax-exempt bond financing, it would have been impossible for even one of these twenty-two facilities to have been built. The reason is simply that given a four- to six-point spread between the interest rate required to support a conventional mortgage, as compared to the lower interest rate required to support tax-exempt financing, debt service expenses, which constitute 15% to 20% of the operating expenses of our typical nursing home, would have made the overall cost of new facilities prohibitive.

Speaking with respect to the health care industry, it can be said that, when interest rates are high (as they certainly have been in recent years), tax-exempt industrial development bond financing provides the only viable method of financing badly needed skilled and intermediate care nursing home facilities. Since such facilities are subject to substantial regulation at state and Federal levels, including ceilings on occupancy costs under state Medicaid reimbursement and Federal Medicare reimbursement, such regulation operates to create a situation where the facilities are simply not economically feasible at interest rates in excess of 13% to 14% (*i.e.*, well below recent conventional rates.) Only by virtue of industrial development bond financing has the health care industry been able to stay abreast of the demand for nursing facilities in the economic climate of the past several years. If the health care industry were not able to keep pace with demand, there is little doubt that government would have to become increasingly involved in the services rendered by the industry, at substantially higher cost both to government and to the taxpayer.

A typical nursing home owned by Health Care Fund is a 100-bed facility. Each such facility provides the full-time equivalent of 65 jobs. That number translates into approximately 80 individual employees, or approximately 1,760 employees in the 22 facilities for which we used tax-exempt financing. Of those employees, approximately 90% are paid at or just in excess of the Federal minimum wage. Categories of jobs in which those 90% are employed include aides, orderlies, security personnel, housekeepers, and assistant cooks. A significant proportion (depending upon location) of that 90% is comprised of minorities. The other 10% are employed in professional jobs such as registered nurses, administrators and dietitians.

Our typical nursing home is located in a city having a population of 50,000 to 100,000, and often is the only such modern facility for many miles around. These facilities serve the socially useful purpose of maintaining aged relatives in close proximity to their families.

In 1969, when I first entered the health care field, the average cost per bed of constructing a nursing home was approximately $4,000. Today, the average cost, utilizing tax-exempt financing, is approximately $20,000 per bed. If tax-exempt financing were not available, the cost per bed would increase materially.

The components of expense with respect to a nursing home include approximately 50% for salaries and wages, 25%-35% for food, medicines, and other operating expenses, and the balance for occupancy cost (debt service or rent). If the cost of financing is significantly increased, occupancy costs will increase proportionately, and such costs cannot be passed on to the patients by virtue of occupancy cost ceilings in the Medicaid and Medicare regulations. Therefore, we could not build these facilities at all.

We have found, based upon our studies and our history of operation, that the average bond issue for construction is approximately $1.5 million and that an average annual payroll for a typical 100-bed facility is approximately $600,000.00. We have also found that state and local payroll taxes and property taxes average approximately $55,000 annually for such a facility. When the Federal income taxes paid by the owners and lessees of such facilities, taken together with the Federal income taxes paid by the employees in such facilities, are added to the state and local taxes mentioned above, it is evident that they more than offset and in fact constitute a significant multiple of the perceived loss in Federal revenues which results from not collecting Federal income taxes on the interest or other income which might have been paid to investors or lenders under alternative financing vehicles. Considering the $1.5 million bond issue and the 80 jobs produced the investment dollars per permanent job would be approximately $18,750. Further, the annual payroll is approximately 40% of the amount of the bond issue.

There appears to be a general misconception that there is insignificant public input at the local level in the IDB approval process. My experience has been entirely to the contrary. In most jurisdictions--including Ohio, Indiana, and Missouri--the applicant for industrial development bond financing must first obtain the approval of a community-based group before the prospective issuer of industrial development bonds will even consider the proposed financing. Thereafter, there are a minimum of two public hearings (sometimes as many as four such hearings) before the prospective issuer will finally commit to issue industrial development bonds. Questions of public benefit, job creation, direct economic benefit to the issuer, competitive effect of the proposed project, and similar questions of state and local interest are fully aired at these public hearings. The local public hearings are almost universally subject to state and local notice requirements which provide the local citizenry with numerous opportunities to appear and speak in favor of or against any particular project or the method of financing involved. This gives the local populace an opportunity for input on the minute details of a proposed project which is simply not available on those infrequent occasions when conventional financing might be available. It should be noted that such hearings are in addition to those which may be required to satisfy state and local planning, zoning and certificate of need requirements.

The patient load in our typical nursing facility consists of approximately 70% Medicare, Medicaid and V.A. patients, with the balance of the patients being those who can pay for the services provided out of private savings or insurance or those who have relatives who can do so. Therefore, any factor, including the availability of industrial development bond financing, which reduces operating expenses in the nursing home inevitably will tend to reduce the cost of providing health care services which are charged to state governments and to the Federal government itself.

The "subsidy" or "tax expenditure" arguments advanced by opponents of this tax-exempt financing neglect or ignore the benefits summarized above. They also neglect the evidence that these programs, administered by literally thousands of state and local officials at no direct cost to the Federal government, represent one of the few bright spots in a national economy devastated by recession.

In conclusion, you have a choice with respect to the health care industry. You can restrict the industrial development bond program and the use of such bonds with the following logical consequences: (1) reduction in the number of nursing home facilities which are required to meet an ever-expanding need; (2) loss of permanent job opportunities, particularly with respect to entry-level jobs; (3) loss of construction jobs; (4) loss of Federal and state tax resources which otherwise would be created as a result of the aforementioned jobs; (5) loss of property tax revenues which would result from the construction of such facilities; and (6) an overall increase in the cost of health care services. In addition to these consequences, we will once again have witnessed the Federal government dictating to the states what is good for them.

In the alternative, we can leave the industrial development bond program intact and continue to achieve the positive economic and human benefits thereof.

STATEMENT OF GEORGE C. PHILLIPS, JR., ACTING CHAIRMAN, COUNCIL OF STATE HOSPITAL AUTHORITIES, WASHINGTON, D.C.

Mr. **PHILLIPS**. Thank you, Mr. Chairman. I represent the Council of State Hospital Finance Authorities, which is an association of 19 State authorities each of which issues tax-exempt securities on behalf of 501(c)(3) hospitals.

The council is concerned by the administration's proposals to impose new restrictions on tax-exempt bonds issued for section 501(c)(3) health care facilities. I have submitted my comments for the record, and I will try to summarize those comments for you now.

We believe that the administration's proposals are aimed principally at curbing the use of tax-exempt financing for private purposes. We believe tax-exempt financing for charitable institutions serves largely public purposes, and so, therefore, is different, and outside of the scope of the limitations intended by the administration's proposals.

The council believes that any new restrictions on tax-exempt financing will adversely effect the Nation's health care delivery system. Tax-exempt financing has played a substantial role in the supply of capital to the Nation's nonprofit hospitals. In 1981, tax-exempt financing for capital was approximately $5.04 billion through such financing. And it supplied roughly half of all capital, new capital, to tax-exempt hospitals. The use by nonprofit hospitals of this form of financing has been necessitated by restrictions on other sources of capital, restrictions in which many cases are the products of or were exacerbated by Federal Government policies. The ultimate result of restricting tax-exempt financing to charitable hospitals in the current environment will be the erosion of the capital base and physical plant of those hospitals.

Tax-exempt financing is necessary to place tax-exempt hospitals on a par with taxable entities. Taxable entities benefit from a large number of incentives to capital investment which do not benefit tax-exempt entities.

We believe that estimates of the revenue effects of tax-exempt hospital financing are overstated. The existing estimates, we do not feel, take into account the number of important factors including, most importantly, the increased cost of taxable hospital borrowings that would increase the amount of medicare and medicaid reimbursement paid by the Federal Government. And that the restriction of the exemption would reduce revenues resulting from reflow effects of hospital investments. When these and other factors are taken into account, we believe that it has not been substantiated that there is any real revenue loss from the exemption of interest on hospital revenue bonds.

The restrictions in the administration's proposals are of concern to the council. First is the contribution requirement. The fact that hospitals are exempt under section 501(c)(3), and these projects are approved by local bodies whose approval is required, we feel, are adequate tests of the public purpose of the hospital financing. For this reason, we feel that the need for a contribution by the State or local government in unnecessary.

The administration proposal provides that the existence of an exemption from tax under State tax law would satisfy the contribution requirement. If such a contribution requirement is imposed, a qualification of this sort would be absolutely essential to the preservation of tax-exempt hospital financing. It's unrealistic to assume that State and local governments would or could commit substantial amounts of general revenues to nonprofit hospital capital projects.

The council feels that the requirement of the approval of an elected board official is unnecessary. In most States, bonds must be approved by a public body to which the legislature has delegated the authority to review and approve bond issuance. Such legislation assures a satisfactory level of political approval of any hospital project.

The council objects as well to the requirement that revenue bonds be in registered form and to the limitation on the arbitrage yield which may be earned on such bonds. Both of these requirements would raise the cost of all revenue bonds. And in the case of arbitrage yield restrictions, might make some particular forms of hospital financing impossible, specifically the FHA 242 and 232 programs.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Phillips follows:]

TESTIMONY OF
GEORGE C. PHILLIPS, JR.,
EXECUTIVE DIRECTOR, ILLINOIS HEALTH FACILITIES AUTHORITY,
ON BEHALF OF THE
COUNCIL OF STATE HOSPITAL FINANCE AUTHORITIES

Thank you, Mr. Chairman. I am grateful for the opportunity to be here this morning, and to share with the Committee the views of the Council of State Hospital Finance Authorities concerning the tax proposals set forth in President Reagan's fiscal 1983 budget.

The Council of State Hospital Finance Authorities is a recently formed association of nineteen state authorities, each created under the laws of its respective state. The principal function of each of the Council's member authorities is to administer and monitor the issuance of revenue bonds for nonprofit health care facilities in its respective state. The health care facilities which benefit from the financing are generally organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code. I am Executive Director of the Illinois Health Facilities Authority, one of the members of the Council, and am also the Acting Chairman of the Council at this time.

The principal concern of the Council with the tax recommendations incorporated in the President's budget relates, of course, to the President's proposal to impose new restrictions upon tax exempt financing for private activities, particularly as those proposals would affect revenue bonds issued on behalf of not-for-profit hospitals. Tax exempt financing for nonprofit hospitals amounted to slightly in excess of $5.0 billion during 1981. The nineteen authorities which comprise the Council of State Hospital Finance Authorities were responsible for administering approximately 40% of these bond issues.

The Council of State Hospital Finance Authorities opposes the President's proposed legislation as it affects section 501(c)(3) organizations in general, and nonprofit hospitals in particular. Section 501(c)(3) hospitals include most of the hospitals in the nation which are affiliated with or sponsored by universities, most church affiliated hospitals, and independent charitable hospitals which play a critical role in the delivery of health services to their local communities. These hospitals, in terms of the number of beds, and in research, training, and teaching, play a dominant role in the nation's health care delivery system.

The Council of State Hospital Finance Authorities believes that availability of tax exempt financing to the nation's charitable hospitals, on the terms and in the manner in which such financing is currently available, enables those hospitals to continue to play the vital role they traditionally have played in the American health care delivery system. We do not believe that it has ever been substantiated that, when all primary and secondary consequences of such financing are properly taken into account, such financing entails any measurable revenue cost to the Federal Treasury.

In appearing today, I wish both to address generally the question of the tax exemption for hospital revenue bonds, and to address specific aspects of the Administration proposal. As to the general policy questions raised by hospital revenue bonds, I would like to stress the role of those bonds in supplying capital to the nation's section 501(c)(3) hospitals, and to detail for the Committee reasons why we believe that the revenue losses from the tax exemption accorded such bonds would not be substantial. We believe, based on these considerations, that no changes are warranted in the current tax exemption as it applies to revenue bonds used to finance hospital projects.

With respect to the particular restrictions proposed by the Administration, the Council of State Hospital Finance Authorities believes that, such restrictions are wholly unnecessary and inappropriate in the context of hospital revenue bonds. We believe that, if implemented, these restrictions would have an undesirable impact on the availability of tax exempt financing to the nation's hospitals. We believe that the application of these proposals to hospital revenue bonds would not and could not make any serious contribution to the reduction of the Federal budget deficit.

The main thrust of the Administration's proposals is to curb the use of tax exempt bond financing for private purposes. Whatever may be the merits of that objective, it is clear that institutions exempt from Federal income tax under section 501(c)(3) do not fall within the intended limitation. Tax exemption for charitable institutions is predicated, in part, on the recognition that such groups provide services which otherwise would become the obligation of government to furnish. Such is clearly the situation affecting charitable nonprofit hospitals. If these institutions did not exist, the medical care and services they provide would be a direct burden upon government. Thus, the availability of tax exempt financing for such groups comports with the underlying rationale that the exemption be utilized in support of public purposes.

* * *

In evaluating the effect of the Administration proposals upon nonprofit hospitals, the first step is to understand the dimensions of the capital needs of those hospitals, and the role which tax exempt financing plays in meeting those needs.

It is true that there has been substantial growth in recent years in the use of tax exempt financing by private nonprofit hospitals. But that growth must be understood in light of the erosion of alternative sources of financing for nonprofit hospitals.

The first tax exempt offering issued in connection with a hospital capital project was issued by Connecticut in 1966. In 1968, the majority of the capital requirements of tax exempt hospitals were still satisfied by conventional sources of hospital equity financing -- namely, government contributions, both Federal and state; private contributions; and internally generated funds -- which at that time supplied roughly 60.5% of the capital of charitable hospitals. Only about 39.5% of the capital requirements of these hospitals was supplied by debt finance, and almost all the debt issued by these hospitals was taxable debt.

A substantial market for tax exempt hospital revenue bonds was first developed during the late 1960s and early 1970s. By 1976, a substantial majority of nonprofit hospital capital requirements (about 67.9%) were met by debt financing, and roughly half of this (or about 30-35% of total capital requirements) was satisifed by tax exempt borrowings. In the years since, the proportion of new hospital capital which has been derived from debt financing has remained nearly constant, in the 60-70% range. Tax exempt financing now constitutes roughly 70% of all debt financing by nonprofit hospitals, and thus supplies about half of all new capital raised by those hospitals.

The distribution of sources of capital for the nation's section 501(c)(3) hospitals has been projected to remain along these orders of magnitude throughout the 1980s. The increasing resort by tax exempt hospitals to debt financing has been stimulated by a number of conditions in the hospital industry which will continue throughout the 1980's to lead hospitals to resort to debt in financing their capital projects in roughly the same proportion as in the immediate past. Perhaps the most significant of these is the method of accounting for a return on capital used in determining Medicare and Medicaid reimbursement payments. Under existing regulations, interest is counted as an allowable cost in computing Medicare and Medicaid reimbursements, which are computed upon a cost of service basis, but no amount is allowed as a return on equity to nonprofit entities, although a return on equity is counted as an allowable cost in reimbursing investor-owned hospitals.

Obviously, tax exempt financing plays a significant role in meeting the capital needs of the nation's charitable hospitals. Such hospitals play a dominant role in the nation's overall health care delivery system. This makes clear that serious questions of health policy are raised by the President's proposals as they would affect hospital revenue bonds.

* * *

The most important grounds for opposing new restrictions on hospital revenue bonds is that such restrictions will adversely affect the ability of the nation's charitable hospitals to continue to deliver high quality health care service. Restrictions on tax exempt financing by hospitals will inevitably lead to the undercapitalization of such hospitals, and to the erosion of the financial structure, capital base, and physical plant of the hospitals, and ultimately of the quality of the delivery system. This is because, as the figures cited above suggest, sources of capital other than tax exempt financing have been greatly eroded by a number of developments in recent years. Many of these developments have been created or aggravated by policies of the Federal Government:

- Government financing is clearly no longer a viable source of equity financing for private section 501(c)(3) hospitals. In the late 1960's and early 1970's, the Federal Government shifted its focus with regard to a number of welfare activities, including health, education and housing, from subsidy for the construction of physical plant to direct subsidy to the user of the services. Educational construction assistance was replaced in part by student loan and student assistance; housing assistance was to some extent supplanted by rent subsidies; hospital construction assistance was supplanted by the Medicare and Medicaid program. Although the dollar volume of financing by the state and local governments increased slightly during the period, it fell far short of compensating for the fall-off in Federal assistance. But neither Federal nor state and local assistance to hospital construction can be expected to increase in any substantial amount in the immediate future, nor would we or the hospital industry necessarily welcome a return to programs of direct Government subsidy to hospital capital projects.

- The amount of financing derived from private contributions can be expected to continue to decline as inflationary and recessionary conditions impinge upon the ability and desire of prospective donors to dedicate substantial portions of their wealth or income to charitable purposes. In addition, the rate reductions in the corporate and personal income taxes enacted in 1981 substantially increase the after tax cost to prospective donors of such contributions.

- Earnings accumulation is also not a promising source of financing. Federal and state reimbursement payments do not fully cover the cost of service; only about 85% of costs are reimbursed under Medicare, and 70% under Medicaid. These percentages will decline further in consequence of recently enacted reductions in reimbursement payments, and will decline further still if new reductions are enacted in this or coming years. Earnings accumulations from nonreimbursed sources are also likely to be impaired in a recessionary economy because of increasing amounts of charitable services performed, and an increasing incidence of bad debt losses to hospitals.

- Taxable debt does not provide a promising alternative to tax exempt financing. At one extreme, the private placement taxable market offers only a very limited prospect for financing nonprofit hospitals. The private placement market is characterized by a small number of very selective investors who invest in only the strongest hospitals. This market is unlikely to be an expanding source of capital for tax exempt hospitals generally. At the other extreme is the publicly traded securities market. But virtually no independent institution, certainly no nonprofit institution, is able to compete effectively with other issuers in this market, primarily because the average hospital bond issue is very small compared to the average corporate securities issue ($12.2 million for an average hospital revenue bond in 1980, compared to $50 to $70 million regularly reported as the size of debt issues by corporate borrowers). It is also very difficult to develop an active

> secondary market in taxable hospital bonds after their initial distribution; no such market now exists. The result is that investors will demand premiums to purchase securities which are issued by smaller borrowers with less established credit standing, and which the investors may be unable to liquidate. Accordingly, the difference in the cost to a hospital borrower between participation in the public tax exempt market and the public taxable market is likely to exceed substantially the normal spread between the cost of tax exempt and taxable financing.

Accordingly, there is virtually no alternative source of financing which will be able to meet the capital needs of the nation's charitable hospitals without an increase in the capital costs to the hospitals greatly disproportionate to whatever cost, if any, the Treasury incurs on account of the exemption of the interest from tax. Consequently, the result of limiting the availability of tax exempt financing to charitable hospitals will be a gradual erosion in the capital base of those institutions. This will result both in the underutilization of health care resources other than physical plant, and a deterioration of health care services provided to the public.

* * *

In addition, in many respects the tax exemption does no more than place charitable hospital borrowers on rough after-tax parity with taxable private borrowers. It must be remembered, in the context of investment by tax exempt hospitals, that such hospitals do not benefit from the variety of tax based incentives to capital investment which are enjoyed by taxable investors, including investor-owned hospitals. When taxable entities finance the construction of a facility, including the construction or improvement of a hospital, they may claim an investment tax credit equal to 10% of the depreciable personalty acquired or constructed with the proceeds of a borrowing, and they will also enjoy substantial tax benefits from the accelerated cost recovery system enacted under the 1981 tax law. These benefits are not enjoyed by tax exempt hospitals, since they pay no tax. But these benefits enable a taxable borrower, with whom tax exempt hospitals must compete for available capital, to pay a higher rate of interest on any borrowing it undertakes. In an environment where capital financing by taxable borrowers is stimulated by investment tax credits and accelerated cost recovery allowances, restricting the tax exemption on the interest on borrowings by section 501(c)(3) organizations is discriminatory against such organizations.

Indeed, the Administration proposal with respect to tax-exempt bonds issued on behalf of private taxable entities reflects a recognition that the availability of the accelerated cost recovery system and tax exempt financing constitute alternative means of encouraging capital investment; the Administration suggests that when a borrower enjoys the benefit of both, he is enjoying a "double-dipping" of tax benefits. Tax exempt hospitals do not benefit from the capital incentives enjoyed by taxable borrowers. Therefore, tax exemption on borrowings by such hospitals is necessary to place them in a competitive position with that of private borrowers.

In this context, too, I believe it is important to address assertions, suggested by the Congressional Budget Office among others, that tax exempt financing leads to the construction of unnecessary hospital capacity. The Council of State Hospital Finance Authorities strongly believes that such suggestions are without foundation. In the first place, it must be remembered that there are substantial government and market place controls on hospital construction. Under section 1122 of the Social Security Act, depreciation and interest expense associated with capital expenditures are not reimbursed unless certain necessary planning approvals are obtained. Accordingly, hospitals will not undertake a financing in the absence of a certificate of need issued by the appropriate state board. Perhaps most important, the market itself exerts controls on the construction of unnecessary projects, since investors will scrutinize any proposed project to determine that the need for the project in the territory the project is designed to serve is such that there will be a reasonable expectation that the project will generate sufficient revenues to service the debt.

A causal relationship between the issuance of tax exempt hospital bonds and the level of aggregate hospital construction has never been demonstrated. The record shows that tax exempt financing has been used principally to refinance existing debt, usually to reduce the cost of servicing outstanding debt, and to renovate existing facilities or to convert them to new uses, rather than for new construction. Since the early 1970's, when tax exempt financing first became generally available to hospitals, and first came to be used to a significant extent, the number of acute care beds per thousand population has not increased substantially. Moreover, there has been a negative correlation between the issuance of bonds and the amount of construction, including renovation, replacement, and facility conversion. From 1972 to 1979, the dollar volume of tax-exempt hospital bond issues increased 670%; but hospital construction starts declined by 40%, and construction completed by 36%. From

1974 to 1979, between 25 and 46 percent of the volume of tax exempt bonds issued were for refinancing existing debt at lower interest rates.

Accordingly, I believe there is no basis for suggestions that tax exempt financing leads to excess hospital capacity. Such financing has been used to fill the legitimate capital needs of a major segment of the nation's hospital industry. Those legitimate needs can be expected to grow over the immediate future, at a time when alternatives to tax exempt financing have been eroded and remain highly unreliable. Accordingly, we believe that this form of financing is essential to maintaining the capital base of the nation's private nonprofit institutions, and that measures to restrict it, like those the Committee now has before it, will jeopardize the ability of these hospitals to maintain adequate physical plant.

* * *

At the same time that hospital revenue bonds play a substantial role in enabling charitable hospitals to maintain their capital base, the Council of State Hospital Finance Authorities believes that it has never been demonstrated that these bonds, when all primary and secondary consequences of their issuance are taken into account, result in a loss of Federal revenues. The Congressional Budget Office has estimated that the revenue savings from eliminating these bonds will amount to about $100 million in the first year following the imposition of new restrictions, rising to about $600 million annually by 1986. We believe those estimates are substantially overstated for at least four significant reasons:

- First, the estimates do not account for the reductions which such financings generate in Federal, state, and local assistance and insurance program reimbursement payments. Tax exempt hospital financing reduces Federal, state and local health care reimbursement payments, so the savings to beneficiary hospitals are passed back to third party cost payors in the form of lower reimbursements for interest expense. The Federal Government receives direct benefits through reduced Medicare and Medicaid reimbursement payments, and this effect will be enhanced if Medicaid is completely federalized, as the President has proposed. In 1980, we believe the reduction in Medicare and Medicaid reimbursement payments offset at least 27% of whatever revenue losses the tax exemption entails for the

Treasury. Another 6% were offset by reduced state and local government reimbursement payments under Medicaid, and other assistance and insurance programs.

- Second, the estimates do not account for increased revenues resulting from the economic activities stimulated by hospital investment in modernization and improvement as well as the expansion of needed hospital capacity. As I indicated above, and as the Administration's analysis of the tax exempt bond issue generally implies, tax exemption for revenue bonds operates in many respects to stimulate investment activity in the same way expedited capital allowances or investment credits operate. The secondary effect of such tax expenditures is an increase in economic activity, which in turn generates a partially offsetting increase in revenue. This effect plays a crucial analytical role in the theory underlying the personal and business tax cuts which were adopted last year, and it should be paid no less heed in assessing the impact of the tax exemption for hospital revenue bonds.

- Third, the estimates overstate the amount of revenue loss caused by the displacement of taxable issues. Many issues of tax exempt debt would not be replaced by taxable debt issues. A substantial number of investors in the tax exempt market would shift investment from tax exempt securities not into taxable securities, but into real estate or other assets the increment in the value of which is not currently taxable.

- Fourth, the estimates do not account for the rate reductions effected by the 1981 Tax Act. The across-the-board 25% rate reduction, and, more important, the reduction of the top maximum rate from 70 to 50 percent, tend to reduce the after tax value of tax exempt bond issues, and to increase the tax exempt interest rate. The income tax rate reductions thus result in less tax loss as a result of exempt bonds, since displaced taxable investments would have been taxed at a lower rate relative to the tax exempt rate.

When all of these circumstances are taken into account and added together, I believe it is possible that their combined effect wipes out the revenue loss estimated by the CBO. Therefore, we believe this Committee and the Congress as a whole should be skeptical of any claim that there will be any measureable revenue gain from proposals to limit the use of hospital revenue bonds.

* * *

In summary, then, the Council of State Hospital Finance Authorities opposes any new restrictions on tax exempt bonds as unnecessary in budget terms, and potentially destructive in terms of health care policy. These considerations are pertinent to any proposal to restrict or eliminate tax exempt financing for hospital revenue bonds.

The Administration proposal, of course, does not propose outright elimination of tax exempt financing for section 501(c)(3) hospitals, but merely proposes certain specific new conditions on their issuance. I would like to comment briefly on some of the specific aspects of the Administration proposals.

Two of the restrictions proposed by the Administration are of particular concern to us. The first is the requirement that financially pressed units of state and local government make additional financial contributions to tax exempt hospital construction projects. The second is the requirement that, in addition to the approval of health planning agencies, rate setting bodies and bond issuing authorities, any exempt bond offering receive the approval of an elected official or body of the government.

We believe that neither of these restrictions would serve any useful purpose, and that each would bear the potential of having an undue adverse impact on hospital revenue bonds.

We do not believe the contribution requirement is necessary to insure that hospital revenue bonds will have a genuine public purpose. The fundamental reason why bonds issued on behalf of section 501(c)(3) organizations are granted exemption is that section 501(c)(3) organizations tend to serve public purposes, and in that respect they shoulder responsibilities which would otherwise have to be borne by the government, whether Federal, state, or local. Under present law whether a hospital revenue bond serves a public purpose is tested, first, by the existence of the Federal tax exemption and, second, by the fact that the state approves the project by means of its own locally adopted procedures. We believe that these two conditions constitute a sufficient test of the public purpose of any municipal bond, including particularly hospital revenue bonds.

Accordingly, we do not believe a contribution requirement of any kind is appropriate in the context of hospital revenue bonds or indeed of other bonds issued for section 501(c)(3) organizations. The Administration proposal does, however, include a caveat which provides that the existence of an exemption of an organization under state tax law, parallel or comparable to the exemption accorded by section 501(c)(3), would satisfy the contribution requirement. We believe that if Congress decides to impose a contribution requirement of some sort, a qualification that such a requirement would be met by the state tax exemption would be essential to the preservation of tax exempt hospital financing. A contribution requirement not qualified by such a provision would virtually destroy the ability of the nation's section 501(c)(3) hospitals to undertake tax exempt financing. We do not believe it is realistic to expect that the nation's hard-pressed state and local governments would, on a widespread basis, be able to make material major commitments out of general revenues to section 501(c)(3) hospital capital projects. If a contribution requirement is imposed, the existence of a state and local tax exemption should satisfy whatever public purpose test is implied or imposed by the contribution requirement.

With respect to the second restriction proposed by the Administration, the requirement of approval by an elected official or body, we believe the restriction is unnecessary and poses potential dangers to the availability of tax exempt financing to section 501(c)(3) hospitals.

Again, as with the contribution requirement, the requirement of approval by an elected official is intended to impose an additional test of the public purpose of any bond issuance. But existing law, and procedures developed in connection with existing law, sufficiently test both the public purpose of bonds issued on behalf of section 501(c)(3) authorities and the degree to which sucn projects bear the ultimate approval of a state's elected officials. The states we represent have each adopted special legislation vesting in a health facilities financing authority, created by act of the state legislature, the power to review and approve hospital capital projects. The adoption of such legislation constitutes a delegation by the elected officials of the state to the financing authority of the power to review and approve the project. Accordingly, every project has ultimate approval from the state's elected officials. Requiring that, in addition, some elected official or body approve each project would introduce delays and additional cost into the issuance process, and might in some circumstances result in making a particular financing impossible. The requirement thus might impair the access of section 501(c)(3) hospitals to capital, without creating any assurances greater than those which now exist that hospital financings receive an appropriate level of local political approval. Accordingly, we oppose the requirement of approval by an elected body.

* * *

For the reasons I have set forth, the Council opposes any restrictions on hospital revenue bonds as a measure for reducing the 1983 budget deficit. We believe that such restrictions would have an unfortunate effect on the health care system of the nation, and would result at best in raising an insignificant amount of revenue.

I welcome the opportunity to answer any questions you may have.

TAX-EXEMPT HOSPITAL BONDS: KEY QUESTIONS AND ANSWERS

by George C. Phillips, Jr.

This year Congress will consider various proposals to restrict tax-exempt revenue bond financing. Some of the restrictions under consideration would substantially reduce the availability of tax-exempt financing to private, not-for-profit hospitals. Although efforts to restrict the issuance of tax-exempt bonds have been made in the past, the threat to tax-exempt hospitals has never been so direct.

While it may be appropriate to restrict the availability of tax-exempt financing to some users, there is no justification for any substantial reduction in health care facilities' access to the tax-exempt market. Indeed, none of the policy concerns advanced against tax-exempt hospital financing supports any change in current law as it applies to tax-exempt hospitals:

- Health policy considerations weigh strongly in favor of retaining the availability of tax-exempt hospital financing. Significant amounts of hospital capital are needed for facility renovation, replacement, conversion and expansion projects. Most of this capital must be raised by issuing debt because of the substantial impairment by the Federal Government of tax-exempt hospitals' other sources of capital. As to the concern that tax-exempt hospital financing leads to excessive hospital expansion, this contention has never been demonstrated and all the evidence shows that this has not occurred.

- The budget policy concern of reducing Treasury revenue losses, presently a major impetus behind efforts to restrict tax-exempt financing, is less applicable to hospital bonds than to any other use of tax-exempt financing. This is primarily because of offsetting reductions in Medicare and Medicaid reimbursement payments for interest expense. For this and other reasons, tax-exempt hospital financing is far less expensive than generally estimated.
- The tax policy issues of whether a public purpose is served by the project financed, reductions in tax rate "progressivity," and the "uncontrollability" of tax expenditures have little force when applied to hospitals. Tax-exempt hospitals serve the unquestionably public purpose of maintaining the health of the community, the same essential public purpose served by public institutions. Any reduction in the progressivity of the tax rate structure is amply justified by this public purpose. In addition, effective governmental controls on hospital capital projects and on the issuance of bonds to finance these projects are already provided by state and local health planning agencies, rate-setting bodies, and bond issuing authorities. Indeed, because tax-exempt hospital financing is administered by a decentralized system of state and local governmental decisionmakers,

this form of financial assistance is a particularly appropriate role for the Federal Government in our federal system.

- The credit policy concerns of capital allocation distortions and increased municipal bond interest rates also have little force in the case of hospitals. The extensive federal involvement in health care financing has an overwhelming effect on the allocation of capital to hospitals, and the volume of tax-exempt hospital bonds is too small a fraction of the bond market to affect significantly municipal bond rates.

None of the policies supporting the restriction of tax-exempt financing would be advanced as much as our health care system would be damaged by any substantial decrease in the availability of this essential form of hospital financing.

Recent Restrictions on Substantially Different Tax-Exempt Bond Users

Congress has restricted the availability of tax-exempt financing twice in the past two years.[1/] In 1980, Congress acted to severely restrict the issuance of mortgage subsidy bonds for single family residences and to terminate their use on December 31, 1983.[2/] In 1981, Congress focused its attention on certain users of small-issue industrial development bonds (IDBs). Hearings were held on perceived abuses of IDB financing, such as the financing of recreational establishments and retail stores, and a report was issued recommending certain restrictions on their use.[3] However, there are substantial factual and policy differences that distinguish hospital bonds from these other types of tax-exempt financing considered by Congress. These other uses were not in furtherance of an essential public purpose such as maintaining the health of the community, were not performed by tax-exempt charitable institutions, and were not subject to any effective form of governmental control.

PROPOSALS UNDER CONSIDERATION

The Reagan Administration, in its FY 1983 budget, has proposed restricting tax-exempt revenue bond financing. Some of the restrictions under consideration as this article is written would virtually terminate the availability of tax-exempt financing to private, not-for-profit hospitals. One such proposal would require that financially hard pressed units of state or local government make additional financial contributions to tax-exempt hospital construction projects, beyond the substantial commitments already made to these institutions in the form of tax abatements. Such additional contribution requirements are not likely to be met in many cases. Another proposal would require that in addition to the approvals of health planning agencies, rate-setting bodies, and bond issuing authorities, an elected official or body also approve the project. This proposal and others would needlessly delay construction and increase project costs.

QUESTIONS AND ANSWERS

The operation of tax-exempt hospital financing and the consequences of substantially restricting its use requires an examination of complex and interrelated questions of health, budget, tax and credit policy. These questions must be answered in the context of the present state of our nation's tax-exempt hospitals and the other elements of our health care system, including: the demand for hospital capital; the expected changes in other federal policies affecting the availability and cost of capital for hospitals; and other unique circumstances of hospital financing.

The balance of this article is a discussion of these questions.

HEALTH POLICY

Q. In this period of budgetary restraint, what special circumstances exist to justify this federal benefit?

A. Tax-exempt financing for private, tax-exempt hospitals is justified by the purposes for which this financing is used and by the impairment of these institutions' traditional sources of capital by actions of the Federal Government.

Estimates of the amount of capital which will be needed by hospitals in the 1980s range from $130 to $190 billion--more than double the amount of hospital investment in the 1970s.[4] This capital is needed to renovate old, inefficient facilities, to replace obsolete equipment (especially in teaching and research hospitals), and to comply with various licensing requirements. It is also needed to convert existing facilities to new uses in response to changed modes of patient care. The introduction of more competition into the health care system is expected to increase the amount of capital required for many of these purposes. Where medically underserved areas exist, caused by population shifts and an aging population, capital is needed for expansion.

Tax-exempt financing for tax-exempt, private, not-for-profit hospitals is especially justified by the charitable nature of these institutions. Historically, these hospitals have improved the health of their communities by providing medical services to those in need, regardless of their ability to pay.

Tax-exempt hospital financing is also justified because the traditional sources of capital for private, tax-exempt hospitals--earnings accumulation, charitable contributions and debt issuance--have been impaired by a variety of Federal Government actions:

- Earnings accumulation has been reduced, and in some cases entirely eliminated, by federal and state reimbursement payments which do not fully cover the costs of service. Only about 85 percent of costs are reimbursed under Medicare and 70 percent under Medicaid.[5/] These percentages will be reduced further by recently enacted reductions in federal reimbursement payments,[6/] and future additional reductions are expected. Earnings accumulation has also been reduced because of increasing amounts of charitable services and bad debts in a recessionary economy.

- Charitable contributions to tax-exempt hospitals are expected to decline as a result of the personal and corporate income tax rate reductions enacted by the 1981 Tax Act.[7/]
- These reductions in earnings accumulation and charitable contributions will necessitate the increased use of debt to finance capital projects. The proportion of construction expenditures funded by debt issuance has been projected to increase from 78 percent in 1977 to over 90 percent in 1983.[8/] Creditworthiness will decrease as debt-to-equity ratios increase and federal reimbursement payments are reduced. These factors will make it increasingly difficult for hospitals to receive investment-grade bond ratings. Under such circumstances, entry into the 30 year long-term bond market becomes much more difficult, often necessitating the use of short-term borrowing. Such borrowing can result in a continual need to roll over increasing amounts of short-term debt, with the ultimate effect of eroding the financial structure of the institution to the point where long-term debt is completely unavailable.

- Current and foreseeable high interest rates make borrowing even at tax-free rates very costly. Much borrowing by hospitals in 1981 occurred despite high interest rates because of the inability of some institutions to delay construction further, because of the rapid escalation in construction costs coupled with the requirement that the project be completed within cost targets mandated by the health planning agency, and because of fears that Congress might restrict tax-exempt hospital borrowing.

  Borrowing at taxable rates would be extremely difficult for many nonprofit hospitals in today's market. The shorter maturity of taxable issues would result in insufficient cash flows because reimbursements for depreciation would be less than required payment of principal. Moreover, the additional cost of taxable issues would not be fully offset by increased interest expense reimbursements.
- Hospitals must compete for funds in credit markets. The borrowing needs of the Federal Government, $41 billion in the first quarter of 1982 alone, as well as the large credit needs of utilities and municipalities, are likely to keep rates from falling substantially for some time.
- This competition for credit has been increased by the Federal Government's recent increases in the supply of

tax-exempt investments. The new "All Savers Certificates" and the expansion of the exemption for Individual Retirement Accounts are prime examples.

- The corporate and personal tax rate reductions of the 1981 Tax Act have increased tax-exempt interest rates by reducing the spread between taxable and tax-exempt rates from the 30 to 35 percent range to the 15 to 20 percent range.

Q. Would tax-exempt hospital financing continue to be justified if proposals to create a more competitive health care environment are implemented?

A. This form of hospital financing would not only continue to be justified, but would be necessary. Vigorous competition among health care providers will be hindered if tax-exempt hospitals, an essential part of our nation's health care system, suffer substantial, perhaps irreparable, erosion of their financial structure, capital base and physical plant. In addition, recent actions of the Federal Government have already biased this competition against tax-exempt hospitals by enhancing the ability of investor-owned institutions to accumulate capital, while hindering the capital accumulation of tax-exempt institutions. For example:

- The Accelerated Cost Recovery System and the corporate tax rate reductions of the 1981 Tax Act assists investor-owned institutions in accumulating capital; tax-exempt hospitals received no such benefit.

- Because tax-exempt hospitals serve proportionately more patients whose care is financed by Medicare and Medicaid than do investor-owned institutions,[9] they will suffer more severe revenue decreases as the result of reimbursement reductions. This disparity is expected to increase as investor-owned hospitals become reluctant to serve Medicare and Medicaid patients at reduced reimbursement levels, and these patients are shifted to tax-exempt hospitals.
- Tax-exempt borrowing helps to put the borrowing cost of tax-exempt hospitals on a basis comparable to the after-tax borrowing cost of investor-owned hospitals. Tax-exempt hospitals cannot take full advantage of tax incentives, such as the deduction of interest and depreciation expenses and investment tax credits, which benefit taxable institutions. Tax-exempt borrowing by tax-exempt institutions is an equalizer between tax-eempt and investor-owned institutions, not an advantage. The denial of tax-exempt financing to tax-exempt hospitals would amount to another action in favor of investor-owned institutions at the expense of tax-exempt institutions.
- Certain Medicare policies amount to additional disparate treatment directly affecting capital accumulation: Medicare reimburses investor-owned hospitals, but not tax-exempt hospitals, for return on

equity, and does not reimburse tax-exempt hospitals for the costs of seeking charitable gifts.

Q. Are there effective controls on hospital construction and the issuance of tax-exempt hospital bonds?

A. Yes. There are effective governmental and marketplace controls on its use. Under section 1122 of the Social Security Act, depreciation and interest expenses associated with a capital expenditure are not reimbursed unless the necessary planning approvals are obtained.[10/] Because denial of such reimbursement in the case of any significant capital expenditure would seriously jeopardize repayment of the debt, a certificate of need or similar approval is a practical precondition to any tax-exempt financing.

In addition, bond issuing authorities can effectively deny tax-exempt financing to projects which are not economically sound or not in the interest of the people of the state. Most important, because the hospital is ultimately responsible for repayment of the debt issued, investors demand that the proposed project is necessary; otherwise the revenues necessary for debt repayment will not be forthcoming.

Q. Has tax-exempt financing led to the construction of unneeded hospital capacity?

A. A causal relationship between the issuance of tax-exempt hospital bonds and the amount of hospital construction has never been demonstrated. Rather, the facts show that tax-exempt financing has been used primarily to refinance existing debt, usually at lower costs, and to renovate existing facilities or convert them to new uses, such as ambulatory care centers which reduce the number of beds and reduce health care costs.

- Since the early 1970s when tax-exempt financing became generally available to hospitals and tax-exempt hospital bonds were issued in significant amounts, the number of acute care beds per thousand population has not increased substantially (from over 4.2 in 1972 to less than 4.5 in 1979). In addition, the rate of growth in this statistic has not increased at all since at least 1960.[11/]
- Since 1972, there has been a strong negative correlation between the issuance of tax-exempt hospital bonds and the amount of hospital construction, including renovation, replacement and facility conversion. From 1972 to 1979, the volume of tax-exempt hospital bond issues has increased 670 percent, and the volume used for construction has increased 660 percent[12/] while hospital construction starts declined by 40 percent[13/] and hospital construction completed declined by 36 percent[14/] (all figures are in constant dollars).
- Of 113 institutions completing tax-exempt financing through 15 state health facilities financing authorities (of 20 authorities active nationwide) in

1978 and 1979, 24 increased bed capacity, while 7 reduced capacity and 82 left capacity unchanged.[15]

- From 1974 to 1979, between 25 and 46 percent of the volume of tax-exempt hospital bonds issued were for refinancing at lower interest rates.[16] Such refinancing lowers the costs of health care by reducing interest expenses.

Q. Is tax-exempt financing an efficient way of assisting hospital investments?

A. Yes. The efficiency (the ratio of hospital savings to Treasury revenue losses) of tax-exempt hospital financing has been substantially understated by the Treasury and the Congressional Budget Office (CBO). It is likely to be higher than the efficiency of the alternative, direct federal subsidy programs, for the following reasons:

- Actual Treasury revenue losses are much less than generally estimated, and may even be less than hospital savings.
- Administrative costs in the issuance of tax-exempt financing are less than comparable administrative costs in federal direct subsidy programs.[17]
- Another important but often overlooked aspect of efficiency is the ratio of the value of the construction project to its cost. Because tax-exempt financing can be arranged much more quickly than a direct subsidy could be approved, construction cost

increases caused by delays (generally estimated to be one percent per month), which add nothing to the value of the project, are minimized.

- The principal source of inefficiency identified by the Treasury and the CBO (returns to high-bracket investors in excess of the after-tax returns on their taxable investments) will be substantially decreased by the recent reduction in the top marginal tax rate from 70 to 50 percent.[18/]

Q. Is this benefit targeted to those projects where capital is most needed?

A. The benefits of tax-exempt financing are directed to needed projects by a decentralized system of state and local government control, rather than by the Federal Government. State health planning agencies, state rate-setting bodies, state bond issuing authorities, and investors effectively direct these benefits to needed projects.

BUDGET POLICY

Q. Would the termination of tax-exempt hospital financing result in a significant increase in Treasury revenues?

A. No. The actual revenue loss caused by the issuance of tax-exempt hospital bonds is much less than the $100 million (in FY 1982) estimated by the CBO, for the following reasons:

1. The CBO estimates do not account for offsetting reductions in federal, state and local assistance and insurance program reimbursement payments.

- Tax-exempt hospital financing reduces federal, state and local health care reimbursement payments because savings to beneficiary hospitals are passed back to third-party cost-payers in the form of lower reimbursements for interest expenses. The Federal Government receives direct benefits through reduced Medicare and Medicaid reimbursement payments, and will benefit even more if Medicaid is federalized as the President has proposed. State and local governments similarly benefit through reduced reimbursement payments in Medicaid and other assistance programs and by reduced premium payments to private insurers, for whom state governments are sometimes the largest customer.
- The reduction in Federal Medicare and Medicaid reimbursement payments in 1980 offset at least 27 percent of the CBO-estimated Treasury losses.[19/]
- Another six percent of the CBO-estimated revenue losses were offset by reduced state and local government reimbursement payments under Medicaid and other assistance and insurance programs in 1980.[20/]

2. The CBO estimates do not account for increased tax revenues resulting from investment-stimulated economic activity.

- All federal tax and direct expenditures are assumed to increase economic activity and thereby increase tax revenues in the amount of approximately 30 percent of the amount of the expenditures. Expenditures which directly induce productive capital investments, however, have a greater than average economic stimulus.[21] This is especially true where nonproductive speculative investments, which are most often used by high bracket taxpayers who invest in tax-exempt securities, are displaced by productive investment activities.

3. The CBO estimates overstate the amount of revenue losses caused by displaced taxable issues.

- Many issues of tax-exempt debt would not be replaced by taxable debt issues. Most refinancing (which accounted for between 25 and 46 percent of all tax-exempt hospital bonds from 1974 to 1979)[22] would not be undertaken at taxable rates.
- In addition, many investors in taxable hospital securities, such as pension funds, pay little or no federal income tax. The replacement of such debt by tax-exempt bonds therefore causes little loss in tax revenues.

4. The CBO estimates do not account for the tax rate reductions of the Economic Recovery Tax Act of 1981 (the 1981 Tax Act).

- The across-the-board 23 percent rate reductions, and more important, the reduction of the top rate from 70 to 50 percent, will tend to reduce the number of tax-exempt bonds issued by increasing the tax-exempt interest rate. The tax rate reductions will also result in less tax loss per tax-exempt bond issued because any displaced taxable investments would have been taxed at a lower rate.
- The reduction in the top tax rate from 70 to 50 percent will increase the percentages of offsetting interest expense reimbursement savings above the 27 percent federal and 6 percent state and local offsets which existed in 1980. By decreasing the difference between the tax brackets of the "marginal" bond buyer and buyers in the highest bracket, hospital savings as a percentage of revenue losses, and hence offsetting savings as a percent of revenue loss, will increase.

TAX POLICY

Q. Does the use of tax-exempt financing reduce the equity and progressivity of our tax system?

A. All tax preferences reduce progressivity. However, this reduction will be lessened by the lowering of the top tax bracket from 70 percent to 50 percent. In addition, any such decrease in tax progressivity is amply justified by the charitable nature of the institutions receiving the benefit of this tax-exmeption and by the public purposes served by the investments assisted.

Q. Are tax-exempt hosital bond revenue losses uncontrollable because they do not require Congressional approval each year?

A. It is true that these revenue losses are not subject to the appropriations process, as is the case for all tax expenditures. However, as discussed above, there are other effective governmental and marketplace controls on the issuance of hospital bonds.

CREDIT POLICY

Q. Does this form of federal assistance for hospital financing distort the free market's allocation of capital?

A. The extensive Federal involvement in health care financing, and thus indirectly in both the supply of and demand for health facilities capital, makes comparisons to capital allocation in a theoretical free market extremely difficult. Tax-exempt hospital financing, however, is less intrusive on the operation of a free market than other forms of Federal involvement in health care.

Q. Does the amount of hospital tax-exempt bonds significantly increase the interest rates, and thus the borrowing costs, for other state and local governmental purposes?

A. There is no evidence that the volume of tax-exempt hospital bonds issued in any area is having a significant effect on municipal bond interest rates. Inflation and federal fiscal and monetary policies are by far the dominant influences on municipal bond rates. In addition, it is no more appropriate to attribute any increase in municipal bond rates to hospital bonds than to attribute such increases to bonds issued for other purposes because the interests served by hospital bonds are no less public than those served by other municipal bond issues. By far the most significant effect on state and local governments of the use of tax-exempt hospital bonds is to decrease their expenditures for health care. This is especially so in states with urban hospitals.

Q. Has the volume of hospital tax-exempt bond issues increased the cost of borrowing to the Federal Government?

A. A comparison of the relative amounts of hospital tax-exempt bonds issued to the level of Treasury and corporate bond issues indicates that the effect of hospital bond issues on Treasury interest rates must be quite small. In 1981, $93 billion of U.S. Treasury were issued, $34 billion of publicly offered corporate bonds (with private issues bringing the corporate total to $47 billion), $45 billion of long-term tax-exempt bonds (with shorter-term tax-exempt financing bringing the tax-exempt total to $80 billion), and $5 billion of tax-exempt hospital bonds.[23/] Therefore, tax-exempt hospital bonds accounted for 11 percent of long-term tax-exempt bonds issued and 6 percent of all tax-exempt issues, and equalled 5 percent of the volume of Treasury bonds issued and 3 percent of the total public bond market.

CONCLUSION

The problem of attracting affordable capital is expected to be the critical issue facing hospitals in the 1980's. Approximately $150 billion will be needed by hospitals in the 1980's for renovation, replacement of obsolete equipment, conversion of facilities to adapt to a new, more competitive environment, and expansion in response to significant demographic changes.

In 1979, tax-exempt financing was the source of 55 percent of all hospital construction capital.[24/] Because of reductions in earnings accumulation and income from philanthrophy, caused in major part by Federal Government reimbursement and tax policies, debt financing will become even more important in the future. Restricting the access of tax-exempt hospitals to the tax-exempt market would make it extremely difficult for many hospitals to finance these projects. This inability to undertake needed capital improvement projects would reduce the quality of patient care in a hospital's service areas and shift the burden of health care to other area institutions, especially already hard pressed public hospitals.

Those hospitals able to finance at taxable rates would suffer cash flow problems and incur higher interest expenses, thus increasing the reimbursement expenses of Federal, state and local governments under Medicare, Medicaid, and other assistance and insurance programs.

The ability of the tax-exempt sector of the health care industry to raise needed capital has been severely and disproportionately impaired by actions of the Federal Government and by the state of the bond market. Further impediments would not materially advance the budget, health, tax or credit policy goals advanced as justification for restriction on tax-exempt hospital financing and would substantially impair the ability of the private, not-for-profit sector of our health care system and the system as a whole to maintain the level of health care we have worked sc hard to attain.

Footnotes

1/ *See generally*, G. Gayer, *The Case For Hospital Tax-Exempt Bonds*, Hospital Financing Management, June 1981 at 58. A. Fine and H. Pell, *Will Hospital Financing Survive Congressional Scrutiny*, Hospital Financial Management, June 1981, at 55.

2/ Omnibus Reconciliation Act of 1980, PL 96-499, Title IX. Also in 1980, the Carter Administration proposed to restrict the issuance of tax-exempt hospital bonds by requiring federal health planning approval of each project seeking such financing; this proposal was withdrawn by the Reagan Administration and was not considered by Congress. 45 Fed. Reg. 41,096-99 (June 17, 1980).

3/ Oversight Committee's Report and Recommendations Relating to Small Issue Industrial Revenue Bonds, May 14, 1981. In a related action, Congress acted to prevent the IRS from expending any funds to enforce a revenue ruling (81-216) which effectively would prohibit state governments from issuing umbrella or pooled bond issues. However, this compromise amendment to the Continuing Resolution funding the Federal Government until March 31, 1982 also provided that enforcement would be prohibited only in the case of IDBs backed by the state or local government, used by firms which had less than $25 million of capital expenditures in a three year period and where the proceeds were not used for various recreational purposes. The adoption of these limits was an ominous precedent for future Congressional action on IDBs and perhaps other revenue bonds as well.

4/ J. Valiante, *The Dimensions of Capital Requirements*, presentation to the National Health Lawyers Association, January 20, 1982; M. Hernandez, S. Valimahomed, *The Capital Formation Environment of the 1980s*, Hospital Corporate Planning, A Report of the 1980 National Forum on Hospital and Health Affairs, at 116.

5/ *Case for Bonds* at 62, *see also*, P. Pine, M. Gornick, J. Lubitz, M. Newton, *Analysis of Services Received Under Medicare by Specialty of Physician*, Health Care Financing Review, September 1981, at 97 (in 1977, Medicare paid an average of 19.5 percent less than average submitted charges); L. Lewin, R. Derzon, R. Marguiles, *Investor-Owneds and Nonprofits Differ in Economic Performance*. Hospitals, July 1, 1981, 56, 58 (nonprofit hospitals price their services to Medicare and Medicaid patients at or below cost).

6/ Omnibus Budget Reconciliation Act of 1981, PL 97-35.

7/ *See* C. Clotfelter, L. Salamon, *The Federal Government and the Nonprofit Sector: The Impact of the 1981 Tax Act on Individual Charitable Giving* (a study for the Independent Sector) The Urban Institute, August 1981, at 23.

8/ Evaluation of Future Hospital Capitalization, a study commissioned by Standard & Poor's Corporation and prepared by Booz, Allen & Hamilton (hereinafter "Booz, Allen"), October 16, 1978, at 7, 8, 21, 22.

9/ L. Lewin, R Derzon, R. Marguiles, Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals, July 1, 1981, 52, 53.

10/ See 42 U.S.C. §1320 a-1.

11/ Booz, Allen, at 4.

12/ Congressional Budget Office, Tax Subsidies for Medical Care: Current Policies and Possible Alternatives (hereinafter "Tax Subsidies"), January 1980, at 49.

13/ American Hospital Association, Report on Tax-Exempt Hospital Financing (hereinafter "AHA Report"), at 6.

14/ Bureau of the Census.

15/ AHA Report at 9.

16/ See Tax Subsidies at 49.

17/ Administrative costs of the Hill-Burton program do not provide a fair comparison because they do not include many costs of financing--costs such as those for document preparation, placement fees, and legal fees--and also because the level of monitoring of that program has been criticized as insufficient by the General Accounting Office. See GAO Report, Hospital Loan Assistance Programs: Actions Needed to Reduce Anticipated Defaults, HRD-79-64, June 27, 1979.

18/ This source of inefficiency is the return received by high-bracket investors above that necessary to attract them from taxable investments. The interest rate spread between taxable and tax-exempt bonds, historically 30-35 percent, reflects the benefit to the borrower and the break-even marginal tax rate at which investors are indifferent between holding taxable and tax-exempt bonds. Investors of tax-exempt bonds in brackets above this marginal rate get a higher return than investors in the marginal tax bracket require to clear the market. Although factors other than the top marginal tax rate undoubtedly influence the tax rate to tax-exempt rate spread, that spread has not narrowed to 15 to 20 percent, indicating a major reduction in this source of inefficiency.

19/ Offsetting reimbursement savings are the product of interest savings to hospitals and the percent of hospital revenues which are paid by the Federal Government. In 1978, the Senate Budget Committee estimated that the interest expense savings of institutions benefitting from tax-exempt financing equalled 75 percent of Treasury revenue losses. On the average, the Federal Government paid 37 percent of the revenues of hospitals benefitting from tax-exempt financing in 1980, primarily through Medicare and Medicaid payments. Because these payments include reimbursement for interest expense on a *pro rata* basis, 37 percent of the savings, which were assumed to equal 75 percent of revenue loss, was passed back to the Federal Government in the form of reduced payments. *See generally*; R. Gibson and D. Waldo, *National Health Expenditures, 1980*, Health Care Financing Review September 1981 (hereinafter "National Health Expenditures"), at 13, 14, 42, 48. (Of the total expenditures for hospital care, the Federal Government paid 41 percent and state and local governments paid 13 percent in 1980. Total hospital expenditures equalled $99.6 billion. Subtracting expenditures at institutions which cannot benefit from the use of tax-exempt financing (Veterans Administration, $4.8 billion, DOD, $3.3 billion, Public Health Services, $1.1 billion, and State and local hospitals, $6 billion) leaves $84.4 billion; Federal Medicare ($26.3 billion) and Medicaid ($5.2 billion) are 37% of this $84.4 billion.)

20/ State and local governments paid 8 percent of hospital revenues through Medicaid and other assistance and insurance program payments. This 8 percent share of the 75 percent savings equals 6 percent of the revenue loss. *See Id*. (Of the $84.4 billion spent on hospitals which can benefit from tax-exempt financing, $6.8 billion (8 percent) was spent by State and local governments: State Medicaid payments ($4.3 billion), State and local workmen's compensation ($1.9 billion) and public assistance ($.6 billion). This does not include $6 billion spent on state and local hospitals.)

21/ In hearings on small issue IDBs, a University of Chicago economist, Dr. Roger C. Kormendi, disagreed with CBO and Treasury IDB revenue loss estimates and their underlying assumptions. Hearings in the House Committee on Ways and Means, Subcommittee on Oversight, April 8-10, 1981. In the study on which his testimony was based, he and co-author Thomas T. Nagle (also an economics professor at the University of Chicago's Graduate School of Business) had concluded that revenue losses due to IDB sales were only one-sixth the amount estimated by CBO. *See also* R. Kormendi and T. Nagle, *A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds* (1981); R. Kormendi and

T. Nagle, The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds, July 26, 1979. Other witnesses cited a 1980 study by the economic consulting firm of Norman B. Ture, who is now Treasury Undersecretary for Tax and Economic Affairs, concluding that the economic activity generated by IRBs causes net gains in federal tax revenues. Norman B. Ture, Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions, at 6.

22/ See Tax Subsidies, at 49.

23/ See, e.g., The Bond Buyer, January 4, 1982, at 18.

24/ M. Lightle, Changes in Sources of Capital for Health Care Providers, presented at National Health Lawyers Association, January 20, 1982.

The Chairman. Senator Grassley.

Senator Grassley. I would like to ask you if you don't think that most private hospitals could meet the test set forth by the administration to gain tax-exempt financing, especially before the 1986 date when municipalities would have to make some financial commitment or contribution. And you probably know what some of those are, but I have six of them down here, like being approved by the highest elected official or legislative body or by referendum; financial contribution by community; if tax-exempt financing is accepted that you would have to use straight line depreciation. And some of those other requirements. Are those difficult to meet or so difficult to meet that we wouldn't be able to take care of most of the needs of financing private hospitals?

Mr. Phillips. Senator, I don't think it's so much a question as to whether or not an individual hospital can meet it. I think the real question is is it economically the best way to provide the least costly financing.

We feel that this will substantially increase the cost of financing. And our role is to provide, where there is a need for a capital project—to provide it in the form that is least expensive to the general public. And we feel that this will increase the cost to the general public.

The Chairman. Last week, the National Retired Teacher's Association and the American Association of Retired Persons testified before this committee that substantial limitations ought to be placed on the use of tax-exempt hospital bonds. They argued that these bonds stimulated construction of unneeded facilities and further escalated medicare and medicaid reimbursement levels for empty beds. The patients themselves are complaining it seems. I guess the first question is, shouldn't we listen to those complaints?

We were also told that there was a $680 million revenue loss for fiscal year 1982 in hospital bonds and that every $1 saved by the borrowing hospitals cost $1.33 in lost revenue. That's not very good business, is it?

Mr. Phillips. Well, let me give you the other side of the story, Mr. Chairman. During the period from 1972 to 1979, the figures that we have show that hospital construction starts declined by 40 percent. And that the construction completed declined by some 36 percent. Now that's raw figures. Also, we did a study—which I will be glad to provide the committee for the record—in 1979 to indicate among the State authorities that participated in this financing as to what kinds of projects and the impact upon total bed capacity within the various States was at that time. And, clearly, the indication is that these capital moneys are being used for renovation and for conversion of facilities to ambulatory-type facilities for the purpose of providing less expensive care to the public rather than more expensive care.

[The information follows:]

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REPORT ON TAX-EXEMPT HOSPITAL FINANCING

Today, tax-exempt bonds provide approximately half of the funds for community hospital construction. Because of this dependence on tax-exempt bonds, continued availability of this source of capital is of concern to the hospital industry. The impact of the use of tax-exempt bonds on hospital capacity, distribution of resources and health care costs is of equal concern to health care regulators. The consequences of rapid growth in the use of tax-exempt bonds by health care institutions and the implications for public policy cannot be evaluated without understanding the structure of the tax-exempt hospital bond market and the types of projects financed by health care institutions using tax-exempt bonds.

The Division of Financial Management of the American Hospital Association, therefore, has compiled this report. Information was taken from various sources, including a survey of the state tax-exempt financing authorities concerning hospital financings completed in 1978 and 1979. Fifteen state authorities provided information about 105 issues, totalling $1.7 billion for 113 institutions, undertaken in this two-year period. Data sources are described in Appendix B.

Summary of Principal Findings

Most tax-exempt hospital bonds are sold to finance private, nonprofit facilities. The percentages of tax-exempt bonds sold to finance public and private institutions are proportional to the existing distribution of capital investments in the hospital industry. Therefore, it does not appear that the increased availability of tax-exempt bonds to private institutions has resulted in a diversion of new capital from the public to the private sector.

The volume of tax-exempt hospital bonds has grown rapidly in the decade of the 1970's. However, health care construction spending has not increased commensurately.

- Use of tax-exempt bonds to finance hospital construction projects has increased by more than 150% between 1973 and 1978.
- This growth has occurred because tax-exempt bonds have replaced other sources of capital that were either more costly (taxable debt) or unavailable (direct government programs).
- There appears to be no correlation between health care construction starts and new money provided by tax-exempt revenue bonds in the period 1974 through 1979. After the Economic Stabilization Program is taken into account, annual hospital construction starts have remained stable at about $2.9 billion. New money

from tax-exempt hospital revenue bonds has increased from $1 billion in 1974 to more than $2.6 billion in 1979.

Of the 15 state authorities that completed the survey and undertook financing in the two-year period, seven reported no projects that increased bed capacity and three of these authorities financed projects that reduced bed capacity.

Refinancing was a significant use of tax-exempt bond proceeds. In the two-year period, refinancing accounted for 29.6% of total uses of funds. Construction, equipment, and other project-related costs accounted for 55.4% of total uses of funds. Twenty-two of the 105 issues were undertaken exclusively to refinance outstanding debt.

The Tax-Exempt Hospital Bond Market

The structure of the tax-exempt hospital bond market has implications for commitment of credit by governmental units and allocation of resources among public and private hospitals. Distinctions among tax-exempt hospital bonds are based on the tax status of the hospital, the relationship between the hospital and the governmental unit, and the extent to which tax appropriations are available for repayment of indebtedness. The two generic types of tax-exempt bonds are:

- Tax-supported bonds, which are repayable from tax appropriations. Tax-supported bonds may be general obligations, which have a claim on all tax receipts of the governmental unit, or limited tax obligations, which have a claim on specific tax receipts. Tax-supported bonds are usually sold to finance public institutions although, in some areas where there are no public hospitals, tax-supported bonds may be sold to finance private institutions.
- Revenue bonds, which are repayable solely from revenues of the institution, rather than from taxes imposed by a governmental unit. Revenue bonds may be sold to finance public or private institutions.

Four types of revenue bonds are distinguished by the entity that issues the bonds and the ownership of the hospital that benefits from the bond issue.

- Authority Bonds. Most tax-exempt hospital bonds are revenue bonds issued to finance projects for private, nonprofit hospitals. Such bonds are issued and sold by an authority or other governmental unit (such as a municipality), and the proceeds of the bonds are lent to the hospital, usually under a note and mortgage or a lease arrangement. This financing technique is known as "conduit financing" because the transaction is essentially between the hospital and lenders; the authority does not lend its credit to support repayment of the indebtedness. The mechanism is used to finance other privately owned projects, such as pollution abatement facilities, low and moderate income housing, and facilities for private colleges and universities.
- Revenue Ruling 63-20 Bonds. Bonds may be issued directly by a private, nonprofit hospital under Revenue Ruling 63-20, which requires the institution to transfer ownership of the financed facilities to the governmental unit on repayment of the indebtedness.

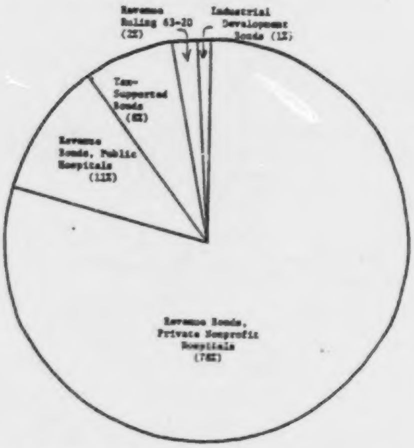
- Industrial Development Bonds. Industrial development bonds may be sold to finance investor-owned facilities subject to the "small issue exemption" (usually $2,000,000 but up to $10,000,000 in certain cases). Such bonds are also issued under a conduit arrangement. Communities offer industrial development bond financing to all types of enterprises to stimulate investment and, thereby, expand employment.
- Public Hospital Bonds. Revenue bonds may be issued directly by a public, nonprofit hospital or agency that operates a hospital. There is no conduit authority and the issuer repays the debt from operating revenues, rather than taxes. This type of revenue bond is also used to finance water and sewer projects, local transit systems and other public facilities.

In 1978, according to The Daily Bond Buyer, $3.1 billion of tax-exempt bonds were sold to finance hospital and medical care facilities, including $250 million of tax-supported bonds, or 8% of the total. An estimate of the composition of the tax-exempt hospital bond market in 1978 is set forth in Graph I. Approximately 78% of all new money issues (that is, issues that involved construction or equipment acquisition) were sold by authorities to finance projects for private, nonprofit hospitals.

The composition of the tax-exempt hospital bond market varies from year to year. In 1979, The Daily Bond Buyer reported that $3.5 billion in tax-exempt bonds were sold to finance hospital and medical care projects; of this amount, $159 million, or 4.5%, were tax-supported bonds.

GRAPH I

TYPES OF TAX-EXEMPT HOSPITAL BONDS
NEW MONEY, 1978



Estimate prepared by AHA, Division of Financial Management

Although a high percentage of new money from tax-exempt bonds benefits private hospitals, this percentage reflects the historical ownership structure of the industry. The distribution of hospital assets is described in Table A.

- Private, nonprofit hospitals comprise the largest sector of the hospital industry in terms of numbers of institutions, beds and plant assets.
- Private, nonprofit hospitals, based on average bed size, are generally larger. Because larger hospitals frequently offer more sophisticated services, they have proportionately greater capital investment needs as reflected by greater net plant assets per bed.

TABLE A

COMMUNITY HOSPITALS
CHARACTERISTICS BY TYPE OF OWNERSHIP

	All Community Hospitals	Private Nonprofit	Investor-Owned	Public Nonprofit
Number of Hospitals	5,851 (100%)	3,339 (57.1%)	732 (12.5%)	1,780 (30.4%)
Number of Beds (in thousands)	975 (100%)	683 (70.1%)	81 (8.3%)	211 (21.6%)
Average Number of Beds per Hospital	167	205	111	119
Net Plant Assets (in millions)*	$39,714 (100%)	$30,430 (76.6%)	$2,274 (5.7%)	$7,009 (17.7%)
Average Net Plant Assets per Bed*	$40,974	$44,816	$28,425	$33,376

Note: Comparisons of characteristics between each type of ownership and all community hospitals are reported as percentages.

* 1977 data; all other data is from the 1978 Annual Survey

Source: American Hospital Association, Hospital Statistics, 1978 and 1979 editions

Growth of Tax-Exempt Financing

Use of tax-exempt bonds to finance construction of community hospital projects has increased by approximately 150% from 1973 to 1978, as illustrated by Graph II. This growth occurred because tax-exempt obligations are providing an increasing share of capital funds.

Shifts in funding sources to tax-exempt bonds are attributable both to a decline in the availability of certain financing programs and to the displacement of other sources of funds.

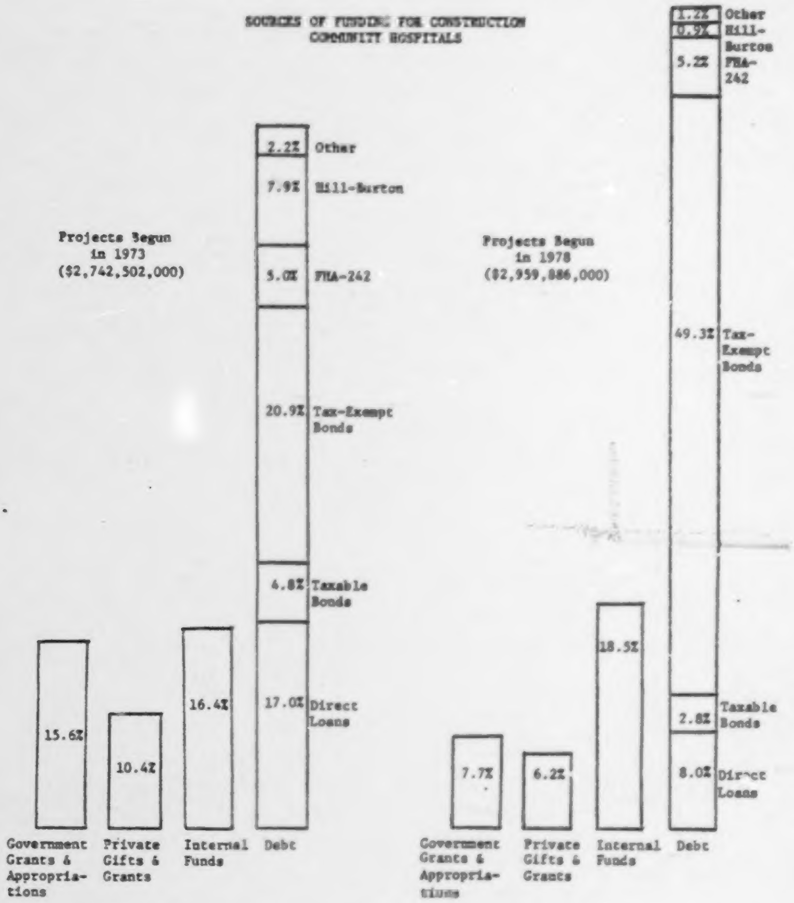
- Government programs (appropriations and Hill-Burton direct loans and guarantees), which constituted 23.5% of total sources of funds in 1973, declined to 8.6% of such funds in 1978, primarily as a result of the discontinuance of the Hill-Burton grant and loan programs.

- In addition, use of taxable debt accounted for 10.8% of total sources of funds in 1978 compared to 21.8% in 1973. Many borrowers prefer tax-exempt bonds to taxable debt because of lower interest costs, and ready availability of funds.

During this period, tax-exempt bonds increased from 21% to 49% of total sources of funds. Almost all of this increase is accounted for by off setting declines in the availability of governmental programs and in the use of higher cost taxable debt.

GRAPH II

SOURCES OF FUNDING FOR CONSTRUCTION
COMMUNITY HOSPITALS



Source: American Hospital Association, Sources of Funding for Construction

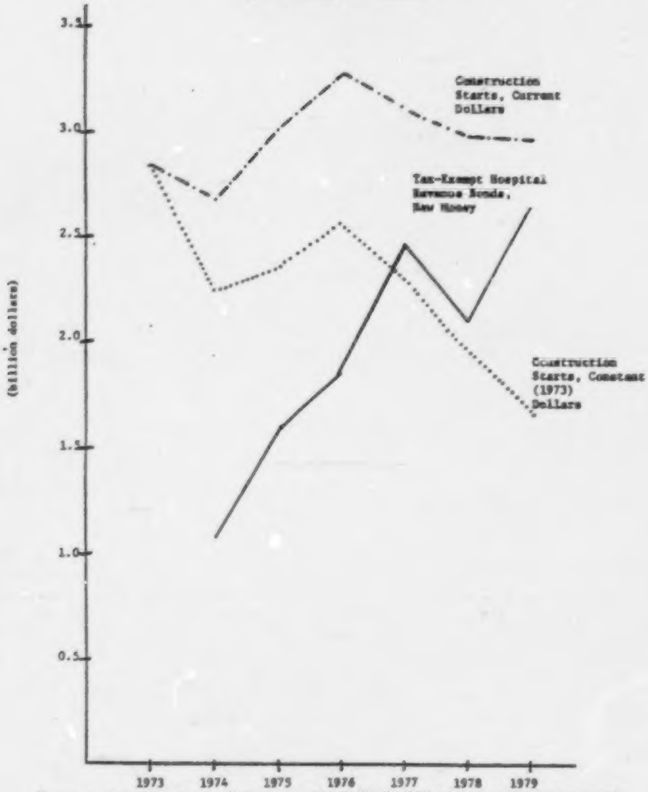
Construction Spending

This growth in the use of tax-exempt bonds by private hospitals occurred during a period when construction spending was relatively stable, as illustrated in Graph III. Economic pressures imposed by the Economic Stabilization Program caused many hospitals to postpone construction and other capital expenditures in 1973 and 1974. When controls were lifted, the backlog of capital investment needs was quickly filled and, as a result, construction starts peaked in 1976. Since 1976, hospital construction starts have declined.

- In current dollars hospital construction starts in 1978 and 1979 were approximately equal to those in 1973.
- After inflation is taken into account, construction starts in 1978 were approximately half the amount in 1973 in real terms.

GRAPH III

COMPARISON OF HOSPITAL REVENUE BOND VOLUME
TO PRIVATELY-OWNED HOSPITAL AND
INSTITUTIONAL CONSTRUCTION



Sources: U.S. Department of Commerce, the Daily Bond Buyer and estimates prepared by AHA's Division of Financial Management.

Since 1974, the annual volume of tax-exempt hospital revenue bonds (excluding refinancings) has grown at a more rapid rate than construction starts. This finding casts doubt on the widely held belief that growth in use of tax-exempt revenue bonds has induced additional health care construction.

History of Tax-Exempt Financing for Private, Nonprofit Hospitals

Growth in the volume of tax-exempt financing for health care institutions occurred as this financing technique became widely available to private, nonprofit health care institutions. The first such conduit financing was completed in 1966 through the Connecticut Health and Educational Facilities Authority for Middlesex Memorial Hospital, Middletown, Connecticut. Today, 23 states have statewide authorities and 35 states have legislation enabling other governmental units to issue such bonds. Eight states have both state and local tax-exempt financing options. Nevada is the only state with no provision for tax-exempt financing for private, nonprofit hospitals. State legislative provisions are summarized in Appendix A.

Table B summarizes the activities of the state authorities that have issued bonds. In 1978, these authorities issued $546 million in bonds to finance private, nonprofit health care facilities and in 1979, $1.141 billion. Almost all of this indebtedness is presently outstanding.

The allegation is often made that tax-exempt bonds are used to finance capital projects that have not been subjected to federally mandated capital expenditure review programs. However, a capital expenditure review program exists in each state that has a tax-exempt financing authority. Furthermore, with limited exceptions, a certificate of need program was in existence when the state authority began issuing bonds to finance hospital projects. In Connecticut and Massachusetts, the first two states to sell such bonds, the financing authority preceeded the certificate of need program. Among the states in this survey, these certificate of need programs were predated only by New York and Maryland. In the other states where the financing authority became active before enactment of certificate of need (Idaho, Maine, New Hampshire, New Jersey, North Carolina, and Vermont), Section 1122 reviews had been established before bonds were issued.

Under certificate of need programs or Section 1122 reviews, capital expenditures in excess of $100,000, changes in bed capacity, and substantial changes in services are subject to review by a designated planning agency. Except for projects that may have been grandfathered under such programs, projects financed through the state tax-exempt financing authorities are subject to capital expenditure review.

TABLE B

STATE TAX-EXEMPT FINANCING AUTHORITIES
PRIVATE NONPROFIT HOSPITAL PROJECTS

State	Certificate of Need Enacted	Year of First Bond Sale	Principal Amount Sold (in thousands) Calendar Year 1978	1979	Close of Most Recent Fiscal Year	Total Amount of Bonds (in thousands) Issued[a]	Outstanding[a]
Alaska	1977	1979	--	$ 12,000	--	$ 12,000	$ 12,000
Colorado	1973	1978	$ 21,975	11,897	9/30/79	21,975	21,975
Connecticut	1969	1966	--	61,300	6/30/79	153,450	119,880
Idaho	1974[c]	1975	2,100	4,415	8/31/79	29,874	28,790
Illinois	1974	1974	99,605	151,139	6/30/79	1,230,029	1,141,817[b]
Louisiana	1973	1974	--	--	6/30/79	93,700	91,400
Maine	1978	1972	--	2,600	6/30/79	66,995	62,265
Maryland	1968	1973	52,115	172,615	6/30/79	198,981	192,957
Massachusetts	1971	1969	7,500	34,110	6/30/79	191,810	175,307
Michigan	1972	1974	56,705	105,399	6/30/79	473,564	458,929
Missouri	1979	1979	--	112,515	--	112,515	112,515
New Hampshire	1973	1971	--	21,230	6/30/79	85,460	82,860
New Jersey	1974	1973	103,410	177,610	12/31/79	580,115	459,504
New York (Dormitory Authority)	1966	1970	73,413	28,215	3/31/79	219,898	202,813
New York (Medical Care Facilities Finance Agency)[d]	1966	1970	--	164,230	10/31/79	1,039,760	1,017,510
North Carolina	1978	1977	110,645	60,995	9/30/79	208,290	206,723
Rhode Island	1968	1976	1,900	4,700	6/30/79	18,960	13,775
South Dakota	1972	1972	15,535	11,575	6/30/79	107,273	88,857
Vermont	1975	1971	915	2,800	12/31/79	14,940	12,078
Wisconsin	1977	1979	--	1,300	--	1,300	1,300
		Total	$545,818	$1,140,645		$4,860,889	$4,503,255

[a] As of last audit; bonds sold in 1978 and 1979 may exceed total amount issued if fiscal year is not the calendar year.

[b] Includes $259,700 for advance redemptions and special obligation bonds.

[c] Section 1122 review.

[d] Includes financing by New York State Housing Finance Agency.

Uses and Sources of Funds

Table C is an aggregate Uses and Sources of Funds from the financings completed by the 15 authorities responding to the survey.

Seventy-five of the 113 institutions that financed through these authorities used bond proceeds to finance new construction. The types of construction projects financed by the state authorities generally involved minimal changes in acute care capacity. Examples of projects include:

- Support facilities necessary but not directly related to patient care, e.g., maintenance areas, cafeterias, living quarters, educational facilities, medical office buildings, and parking garages (a fairly typical project to be included in these financings). Perhaps the most unusual project was a helipad and a rapid transit system linking parts of a major medical center.
- Modernization and conversion of heating and cooling systems as well as measures to improve the efficiency of existing energy systems.
- Alternatives to traditional acute care, e.g., ambulatory care facilities and conversions of existing bed capacity. One innovative project converted a hotel to a retirement center that provides health services to residents.

Expansions often were undertaken in connection with renovations or replacements. It was impossible, therefore, to determine whether the expansions represented new capacity or increases in square footage to accommodate existing services.

Refinancing was a significant use of proceeds. Twenty-two of 105 issues were undertaken exclusively for this purpose; the principal amount of these issues totaled $100,263,051 in 1978 and $241,821,420 in 1979. Part of the proceeds of 40 other issues was also used for refinancing.

Refinancing is the substitution of one source of capital for another. Proceeds of a refinancing are not used to acquire physical assets. There are many reasons a refinancing may be undertaken. Two of the most common are:

- To lower the cost of borrowing
- To facilitate future financing by eliminating restrictions and encumbrances imposed by prior lenders.

Among the projects financed with tax-exempt debt, bond proceeds accounted for 83% of total sources of funds in the two years. However, hospitals have recurring capital needs, and projects financed with tax-exempt bonds are only part of all capital investment. The percentage of sources of funds from bond proceeds should, therefore, not be construed as representative of financing of all capital investment by hospitals or even financing of all construction.

Effects on Bed Capacity

One of the criticisms of tax-exempt bonds is that their availability has induced unnecessary capital spending, particularly new bed construction. The findings of the survey do not support this result.

TABLE C

STATE TAX-EXEMPT FINANCING AUTHORITIES
PRIVATE NONPROFIT HEALTH CARE PROJECTS

USES & SOURCES OF FUNDS
(in thousands)

		1978		1979	
	Uses	Amount	Percentage of Total	Amount	Percentage of Total
1.	Site Acquisition and Development	$ 2,728	0.41%	$ 13,439	1.06%
2.	Construction Contract	284,201	43.22	594,589	47.07
3.	Architects and Engineers' Fees	21,446	3.26	37,578	2.97
4.	Fixed Equipment (not under contract)	22,746	3.46	22,703	1.80
5.	Movable Equipment	15,456	2.35	48,634	3.85
6.	Interest Expense Capitalized during Construction	36,013	5.48	77,043	6.10
7.	Principal Amount Existing Debt Refinanced	207,648	31.58	341,547	27.04
8.	Reserves Funded from Proceeds	19,116	2.91	72,180	5.71
9.	Fees (consulting, legal, financing, etc.)	38,436	5.85	33,747	2.67
10.	Other (contingency, etc.)	9,752	1.48	21,797	1.73
	TOTAL USES	$657,541	100.00%	$1,263,257	100.00%
	Sources				
1.	Bond Principal	$516,343	78.53%	$1,081,338	85.60%
2.	Interest Earned on Funds Held During Construction	14,911	2.27	45,471	3.60
3.	Hospital Contributions	68,197	10.37	114,823	9.09
4.	Other Sources (Grants, Appropriations, etc.)	58,089	8.83	21,626	1.71
	TOTAL SOURCES	$657,541	100.00%	$1,263,257	100.00%

Note: Numbers may not add due to rounding.

Source: AHA, Division of Financial Management, survey of state tax-exempt financing authorities.

- Of the 15 state authorities responding to the survey, seven reported no projects that increased acute care bed capacity. Three of these authorities financed projects that reduced bed capacity over the two-year period.
- Of the 113 institutions completing financing, 31 undertook projects that changed bed capacity. Of these, 24 institutions increased capacity; seven decreased it.

Among the 24 hospitals that increased bed capacity, the number of new beds ranged from 1 to 312. The 312-bed increase, however, included shelled-in space for 104 beds so the actual increase in capacity was 208 beds. Thirteen of the projects involved 25 or fewer new beds, including seven projects that added 10 or fewer new beds. Only five projects resulted in additions of 100 or more beds each.

The following descriptions are representative of the projects in which bed capacity increased:

- A 438-bed hospital, replaced its pediatric beds with additional medical-surgical beds, increased the number of medical-surgical and respiratory intensive care beds, and added rehabilitation and intermediate care beds to its coronary care facilities. Total bed capacity increased by 24 beds.
- Four other projects involved addition or expansion of intensive care or cardiac care units.
- A predominantly long-term care hospital increased its acute care capacity from 20 to 30 beds and closed 6 long-term care beds. On completion of the project, the 301-bed facility will have 112 private rooms, compared to 10 private rooms formerly. Private rooms maximize the hospital's flexibility to provide medical isolation as well as patient privacy.
- In two projects, existing space was converted to provide additional bed capacity. A psychiatric hospital converted an existing service building to a 30-bed unit. However, the project will result in a total increase of 10 beds for the hospital; some beds in the unit will be relocated from other parts of the institution. In the other instance, a heart and lung specialty hospital added 25 beds in existing shelled-in space.
- Two projects involved expansion of long-term care facilities. One project combined and expanded an existing skilled nursing facility and nursing home into a long-term care center for the aged blind; the center provides all-around medical care. The other project was a 215 bed long-term care center for the elderly that was part of a $40 million complex of services for the elderly including a 700 unit apartment building, a 200 unit lifetime care facility, and a village of common shops.

Most of the changes in bed capacity resulted from long-range planning studies that addressed modernizations, expansions, and changes in the bed capacity of outmoded facilities. Changing medical practice patterns, technological improvements, the need to meet changing demands in the type of services needed and regulatory requirements have forced many institutions to reevaluate their services, especially in the context of the relation between an institution and its community.

Implications of Tax-Exempt Financing

Tax-exempt financing for hospitals has grown in recent years because it offers significant advantages compared to other sources of funds. These include lower interest cost than taxable debt and ready availability of funds.

Hospitals have organized their capital financing activities to capture these benefits. First, hospitals are refinancing outstanding debt. In most cases, refinancing lowers the cost of borrowing, but, equally importantly, it places the hospital in a position to borrow in the tax-exempt market to finance future capital needs. Second, hospitals are grouping together small, diverse capital expenditures to achieve economies of scale and benefit from the lower cost of tax-exempt debt. The types of projects financed generally involved minimal increases in capacity.

The amount of refinancing will significantly affect the total volume of tax-exempt hospital bonds. Until long-term interest rates decline significantly, most hospitals will be unable to realize savings in borrowing costs by refinancing outstanding tax-exempt debt. Due to differences in interest rates between taxable and tax-exempt markets, a few hospitals will be able to lower borrowing costs by refinancing outstanding taxable debt with tax-exempt bonds. However, such activity is diminishing because taxable debt has been refinanced by many borrowings and is used less frequently as a source of new capital.

If tax-exempt bonds become unavailable, due to either legislative action or adverse market conditions, there will be serious adverse consequences for hospitals. It appears that hospitals will respond by substituting higher cost, taxable debt as a source of financing for capital projects. Financing requirements initially will be reduced because refinancing would not be attractive at taxable interest rates. However, if private hospitals are foreclosed from the tax-exempt bond market for an extended time, hospitals may be forced to refinance outstanding tax-exempt debt with taxable debt in order to fund future capital needs. Whether such refinancing occurs, the higher interest cost of taxable debt cannot be ignored.

Tax-exempt bonds are only one source of capital funds available to hospitals. This report suggests that restrictions on availability of one source of capital, even a source as significant as tax-exempt bonds, will have little effect on capital investment.

Mary Alice Lightle
Beverly J. Hawkins
Division of Financial Management
American Hospital Association

June 1980

APPENDIX A

HEALTH FACILITIES FINANCING AUTHORITIES

STATE	STATE AUTHORITY FOR ISSUING TAX-EXEMPT BONDS	STATE LEGISLATION ENABLING GOVERNMENTAL UNITS TO ISSUE TAX-EXEMPT BONDS
Alabama	-	X
Alaska	X	-
Arizona	(1)	X
Arkansas	-	X
California	(2)	X
Colorado	X	X
Connecticut	X	-
Delaware	(4)	-
District of Columbia	-	-
Florida	-	X
Georgia	-	X
Hawaii	X	-
Idaho	X	-
Illinois	X	X
Indiana	-	X
Iowa	-	X
Kansas	-	X
Kentucky	(1)	X
Louisiana	X	X
Maine	X	-
Maryland	X	-
Massachusetts	X	-
Michigan	X	X
Minnesota	-	X
Mississippi	-	X
Missouri	X	-
Montana	-	X
Nebraska	-	X
Nevada	-	-
New Hampshire	X	-
New Jersey	X	-
New Mexico	-	X
New York	X	(3)
North Carolina	X	X
North Dakota	-	X
Ohio	-	X
Oklahoma	-	X
Oregon	-	X
Pennsylvania	-	X
Rhode Island	X	-
South Carolina	-	X
South Dakota	X	X
Tennessee	-	X
Texas	-	X
Utah	-	X
Vermont	X	-
Virginia	-	X
Washington	(2)	-
West Virginia	-	X
Wisconsin	X	X
Wyoming	-	X

(1) Established but inactive. (2) In organizational stages (3) Suffolk County only.
(4) In litigation.

May 1980

APPENDIX B

SOURCES OF DATA

Four principal sources of data were used to develop this report:

- Sources of Funding for Construction. This survey has been conducted annually since 1973 by the American Hospital Association's Data Center. The objective of the survey is to obtain information on sources of funding for hospital construction projects begun during the calendar year. Information is reported only for hospitals responding to the survey. Total sources and uses of funds for capital projects for all hospitals are not projected.
- U.S. Department of Commerce, Bureau of the Census. Quarterly, the Department of Commerce prepares estimates of privately owned non-residential building projects started, completed, and under construction. Hospital and institutional construction includes hospitals, outpatient surgical facilities, nursing homes, and similar facilities.
- The Daily Bond Buyer. Tax-exempt bond issues sold to finance hospital and medical care facilities have been reported by The Daily Bond Buyer since 1974.
- Survey of State Authorities. The state health care financing authorities were surveyed to obtain specific information about financings for private, nonprofit health care facilities completed in 1978 and 1979. The facilities include hospitals, nursing homes, and other health care institutions. Information is reported only for authorities responding to the survey. Estimates of all tax-exempt hospital bond activity were not developed.

Data from these sources are not interchangeable because:

- different survey techniques are used;
- different types of health care institutions are included within the scope of each survey;
- events recorded by one survey may not be analogous to or coincide with events recorded by another survey;
- most data reflect only part of project outlays or sources of funds for a particular project.

The Chairman. Well, again I can understand the concern of the witnesses, but I hope you appreciate our bigger problem. It would be quite helpful if you would give us some ideas where we could save some money instead of telling us that we shouldn't do anything. We will do something. We may do the wrong thing unless we get some counsel and advice from the people who come before this committee.

We are looking at different facts. If we adopted the administration's proposals—maybe their numbers are exaggerated—but we would start picking up substantial savings: $300 million in 1984; over $1 billion in 1985; up to $2 billion in 1986. And it gets larger and larger in the outyears. And I am not suggesting that the administration's proposal is letter perfect. It probably will be modified. But there is, I think, substantial sentiment that we have to do something in this area. It doesn't help us much for everybody to say we don't want to do anything. And then we go off and do our own thing which may or may not be the best solution. But you are experts. You deal with it on a daily basis. We deal with it, obviously, not that often. But certainly you know some areas where we can save some money where it won't hurt too terribly much. And I don't think it would be awful for people to pay taxes—the rich, at least. So those are the areas that we are looking at.

Mr. Mitchell. Senator, may I make one observation?

The Chairman. Sure.

Mr. Mitchell. One of the concerns that we have is that if, in fact, public purpose, as served by charitable hospitals, is amended under this proposal to cause charitable institutions to pay more for the investment that has to be made, whether it's for remodeling, renovation, equipment or in some cases reconstruction—if that has to increase the cost of those projects, that is going to be a direct passthrough to the Federal Government through current medicare and medicaid reimbursement programs.

The Chairman. Well, we are going to change those, too.

Mr. Mitchell. Yes, sir. Then that ought to be examined as part of this matter.

The Chairman. We are looking at prospective payment, not reimbursement. It's the same thing, I guess. We are looking at a lot of areas to try to whittle down the cost of medicare and medicaid. The programs are almost out of control. Again, we are looking to hospitals and physicians for help in those areas because they are the experts. They deal with those programs.

Well, I understand your concern. And certainly we don't want to destroy key features of a good program, but I can't believe that we can't modify some without doing violence to the program.

Mr. Thompson. One comment, Mr. Chairman. A couple of things that stand out would be the 1-percent contribution thing. That strikes me as being difficult in your administration of it.

The Chairman. Why would that be so difficult? Why couldn't you have a tax abatement or——

Mr. Thompson. I believe in Ohio it might take a constitutional amendment. I am not sure about that, but it might. In order for the authority to contribute that money to the project. It might be a problem.

The CHAIRMAN. Well, it doesn't take full effect until 1985. As quickly as they move in Ohio, I'm certain they can do it by then. [Laughter.]

But those are some of the real concerns.

Well, thank you very much.

Mr. THOMPSON. Thank you.

Mr. PHILLIPS. Thank you.

The CHAIRMAN. Our next panel will be Mr. Philip C. Johnston, counsel, the Small Business Coalition for Pollution Control; Mr. Ronald Bean, president, Council of Pollution Control Financing Agencies; Mr. Richard C. Hawk, president, Higher Education Assistance Foundation.

I guess you know which order you are to appear. And I would appreciate it very much if you could summarize your statements. Senator Baker has asked that all the committee chairmen meet him at 11:30, and we have another committee meeting that I have to attend. I may have to recess these hearings temporarily, but at least we will start. If you can summarize your statement. It would be helpful. We will start with Mr. Johnston, Mr. Bean, and then Mr. Hawk.

STATEMENT OF PHILIP C. JOHNSTON, COUNSEL, THE SMALL BUSINESS COALITION FOR POLLUTION CONTROL, WASHINGTON, D.C.

Mr. JOHNSTON. Mr. Chairman, I am Philip C. Johnston, a partner in the law firm of Vorys, Sater, Seymour, and Pease, based in Columbus, Ohio, with offices here in Washington. I am here today on behalf of the Small Business Coalition for Pollution Control to which our firm is counsel.

Mr. Chairman, I will depart from my prepared remarks, and I believe you have a written statement for the record.

The CHAIRMAN. Yes.

Mr. JOHNSTON. The one thing I would appreciate doing is reading a letter that I just received before coming here from Gov. James Rhodes of Ohio, which summarizes one of the two concerns that I wish to express here today. It's addressed to the Honorable Robert J. Dole, chairman, Senate Committee on Finance, Washington, D.C.

> Dear Senator Dole: On behalf of the people of Ohio, I call upon your Committee, and the Congress as a whole, to take whatever steps are necessary to reinstate a small but vital federal loan guarantee program that is being destroyed by an arbitrary decision of the Office of Management and Budget.
>
> That program is one by which the Small Business Administration is guaranteed tax-exempt financing for pollution control facilities. OMB has, by pure executive fiat, ordered that SBA not guarantee any pollution financing except on taxable issues. The SBA program has been extraordinarily effective in helping small businesses throughout the country to meet federally mandated pollution control at no cost to the Federal Government.
>
> The program has usually entailed the sale of SBA guaranteed bonds, which are free from federal income taxation. In Ohio, 19 companies employing 1,498 people have had their pollution control bond issues guaranteed in the total amount of $36,470,000. We believe that many of these businesses would not have been able to finance their compliance with the pollution laws in the normal financial market. The impact on those companies and employees from violating those laws could have been tragic. But that was just the beginning. Twenty-six more Ohio companies employing 2,127 people already have been issued inducement resolutions to finance an additional $46,060,000 of pollution control facilities.

OMB's policy shift has put their projects in the deep freeze and their futures in jeopardy. And we know of at least 60 to 80 more small businesses in Ohio employing from 3,000 to 4,000 people who are in varying stages of the SBA application process. Without SBA guaranteed tax free financing, these companies, and many others who don't know yet that they have pollution compliance problems won't be able to finance the mandated compliance.

Ohio will find itself in the unpalatable position of having to enforce federal pollution laws against Ohio businesses who are violating those laws because of the federal policy changes which destroyed their ability to comply. That is bad government.

We hope that you will be able to convince the few individuals in the Administration who have decreed this arbitrary change to reverse themselves. But if that does not occur, we ask that you promptly develop legislation to require that the SBA continue to guarantee tax-free pollution control financing at the levels previously recommended by Congress.

Yours very truly, James A. Rhodes, Governor.

As I said, I am here to express the concern for this particular program which is being operated or authorized, first, much below the $250 million authorized by Congress, and, second, with a directive from OMB that there be no tax guarantees for tax-exempt bonds.

Further, I am here to express concern over the administration's proposals: For example, a local contribution requirement would adversely effect the abilities of small businesses to finance pollution control facilities. That would be a concern because we doubt, frankly, that local communities are going to allocate their resources to helping someone who needs to put something in to stay in the printing business or the electroplating business or whatever versus the new business that is coming to town.

At this point, I think I will conclude my initial remarks, Mr. Chairman.

[The prepared statement of Mr. Johnston follows:]

STATEMENT OF PHILIP C. JOHNSTON, COUNSEL TO THE SMALL BUSINESS COALITION FOR POLLUTION CONTROL, BEFORE THE SENATE COMMITTEE ON FINANCE, WASHINGTON, D.C., MARCH 17, 1982.

THE OFFICE OF MANAGEMENT AND BUDGET'S AND TREASURY'S ATTACKS ON THE SBA'S POLLUTION CONTROL FACILITIES FINANCING GUARANTEE PROGRAM: A CASE STUDY IN COUNTERPRODUCTIVE CONSEQUENCES

Mr. Chairman and Members of the Committee:

You and this Committee are to be congratulated for holding these important hearings. Their focus on industrial development and revenue bond taxation and the resolution of the outstanding issues associated with them which should emerge from your deliberations should restore the predictability to transactions based upon such bonds and to the business activity and jobs creation which arises from their use. That resolution, predictability, business activity and jobs creation are all needed today.

My testimony today is offered on behalf of The Small Business Coalition for Pollution Control and is directed at the Office of Management and Budget's (OMB) and Department of the Treasury's attacks on the Small Business Administration's (SBA) pollution control facilities industrial revenue bond financing guarantee program. My testimony is offered within a context, however, and that context is my fourteen years of experience with this type of financing. It is offered in that context for two reasons: first, OMB's and Treasury's attacks on this particular program are part of their coordinated attacks on IRBs/IDBs in general and, second, this Committee's and this Congress's resolution of the broader issues may impact, favorably or detrimentally, on this particular program.

The bottom line which we wish this Committee and Congress to address and the Administration to recognize with respect to this particular program is that the Administration's policy objectives (reducing both the Federal Government's crowding out of available capital and potential tax revenue losses to the Treasury) has here reached, and is threatening to destroy, an important program and that this is happening without an adequate understanding on the part of those persons who formulated the policy objectives of what the real consequences to those objectives have been and are.

These real consequences include their undermining of other policy objectives of the Administration: jobs creation, increased productivity, environmental protection and tax revenue generation. As a recent letter from Governor James A. Rhodes of Ohio sets forth, jobs are an important consequence of this program, some nearly 8,000 in Ohio alone. I ask that this letter be made a part of this testimony at its conclusion.

The Small Business Coalition for Pollution Control

I am Philip C. Johnston, Counsel to The Small Business Coalition for Pollution Control. I serve in that capacity as a partner in Vorys, Sater, Seymour & Pease, a Columbus, Ohio general civil practice firm of national reputation in the relevant corporate, bond, tax and environmental compliance areas. The firm is counsel to the Coalition.

The Coalition was organized last year to heighten the awareness of Congress, the Administration and the public on alternatives before them in determining the future of the SBA's pollution control facilities and equipment financing guarantee program. The Coalition represents the small businesses which have, on the one hand, been required to install pollution control facilities and/or equipment in order to meet pollution control objectives of the Government and which, on the other hand, would face either (1) noncompliance with the statutes, regulations, plans and orders reflecting those policies, or (2) a sale to a bigger business with more assets and borrowing leverage, or (3) insolvency and reorganization, if forced to over-leverage against net worth made lower by the borrowing, or (4) going out of business. Facing these alternatives is a substantial, additional burden being borne by these small businesses.

Few in business know the adverse impacts of the Federal Government's "crowding out" of available capital more than small businesses. Small business is usually the first driven out of the capital market and the last back in. It is the first hit by the high interest rates which inadequate capital can produce[1].

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[1] The November 1981 report of the National Federation of Independent Business, "Report on Small Business in America's Cities," ranked problems posed by high interest rates as the number one problem faced by the small businesses surveyed.

The president of the Coalition is Jack L. Schaefer, president of The Specialty Papers Company, a small business printing company in Dayton, Ohio. The company is an SBA loan guarantee applicant, and its officers and employees are aware of the consequences of a failure by this Administration to act in a timely way to allow SBA to proceed with this program (1) at an annual authority level consistent with the law (P.L. 97-92, the FY82 Continuing Resolution) and (2) with the guaranteeing of tax-exempt bonds, a guaranteeing consistent with the statutes, their legislative history and six years' experience.

Mr. Chairman, it is appropriate to look at the history of this particular SBA program, the continuing need for it, the issues which are presently associated with it, and a context for their resolution.

History of the SBA Pollution Control Facilities Program

The Small Business Administration's pollution control facilities financing program is really a pollution control facilities and equipment financing program. It was authorized by sections 102-103 of the Small Business Investment Act of 1976 (P.L. 94-305, 90 Stat. 663, 15 U.S.C. 692, 13 C.F.R. 111) in order to allow small businesses to obtain access to the tax-exempt bond markets for the financing of plant changes and equipment mandated by pollution control (air and water pollution control and solid waste management) regulation by the Government.

That Act authorized SBA to guarantee up to one hundred percent of the payments due from eligible small businesses under qualified contracts for the planning, design, financing or installation of pollution control facilities and/or equipment.

The current limit on a loan guarantee is $5,000,000 principal plus interest, and the average is $1,200,000. The maximum term of the loan is 30 years; the average is 20 years. What is guaranteed is a qualified contract, and the applicant must demonstrate the need to overcome financing disadvantage in order to qualify. The applicant pays a guarantee fee of 3.5-percent times principal plus interest, less an escrow deposit of 3 monthly payments. In the event of default, payment is made from the escrow fund first, then from the fund created by the guarantee fees collected and the interest earned thereon. The $15 million revolving fund established by Congress at the beginning of the program has grown through the addition of these fees to over $30 million, and it is our understanding that the only defaults in its history are being, or can be, recovered by SBA through subsequent agreements with the defaulting small businesses.

The Continuing Need

Why is this Federal Government guaranteed and tax-exempt financing necessary? Principally for two reasons:

1. Extensive facility and equipment expenditures are necessary to control air and water pollution and manage solid

waste disposal in order to comply with Federal, State and local environmental policy objectives; and

2. Obtaining ordinary debt financing without the guarantees is nearly impossible because of (a) the disproportionate cost of the equipment in relation to most small businesses' net worth and profitability and (b) the equipment itself generally has little collateral value because of its uniqueness to plant and other equipment.

This need has been reflected by the growth in applications received and loan principal guaranteed, a growth which has not diminished even during the past year's disruption of the program. In a capsule, the growth and the need that growth reflects has been as follows:.

Year	Companies Assisted	Principal	Aver. Prin./Co.
FY77	12	$ 5.7 million	$ 475,000
FY78	14	9.9 million	707,143
FY79	45	41.5 million	922,222
FY80	77	98.5 million	1,279,220
FY81	66	99.9 million	1,513,636

It must be stressed here that the number of applicants measured against the limited available authority assures that this program is indeed one of "last resort." That notwithstanding, SBA has $129 million of pollution control applications which have been received by it during the past 18 months. There are $35.6 million in commitments outstanding and $93.4 million awaiting processsing.

The Issues

This continuing, if not growing, need notwithstanding, the Administration has forced issues to swirl around it over the past year.

When the Coalition was organized last year, there were three issues:

1. The level of FY82 annual authority to be apportioned to SBA for this program by the Office of Management and Budget (OMB);

2. A resolution of the tax status of the bonds to be used to finance pollution control facilities and equipment; and

3. Whether the personnel ceiling for SBA's Pollution Control Financing Section, a ceiling also controlled by OMB, would be adequate to permit that Section to close on guarantees equal to the annual authority level.

We knew then that if any link in this three-link chain broke, the SBA pollution control facilities guarantee program would be severely endangered. We know this very well today.

These three issues remain. Only two things have happened: First, these issues have been more precisely refined and, second, this refinement has occurred because OMB has acted by fiat as to the first and second issues and not at all as to the third. The Coalition and its members believe the OMB actions as to the first and second issues to be without foundation in the law.

The Fallacies Inherent within OMB's and Treasury's Attacks on this Program

OMB and Treasury, representing themselves as the Administration on this issue, have attacked this program by curtailing its annual authority ceiling and by prohibiting its use in association with tax-exempt industrial revenue bonds. In short, OMB and Treasury have contended that the existence and level of annual authority consitutes an unwarranted intrusion in the capital markets and that the guaranteeing of tax-exempt issues results in tax revenue losses.

Both contentions are demonstrably wrong. And they are wrong because the real consequences are not what OMB and Treasury see them to be.

As to the instrusion of the level of annual authority into the capital markets, such intrusion exists whether the bonds are taxable or tax-exempt. It is still the same dollar level; the same "level of intrusion." A $150 million guarantee of taxable bonds is the same as a $150 million guarantee of tax-exempt bonds; no more, no less. There simply is no difference.

The more important OMB and Treasury reason must be, therefore, to avoid potential tax revenue losses by requiring the financial activity to be a taxable event. But this is not going to happen. There is within the United States today no existing capital market for Federally guaranteed taxable issues. One would have to be created by the investment banking community working with these small businesses. Given the characteristics of these bonds (usually 20 years, etc.), including their taxable nature, where would this market be created? Where would these bonds be sold? The Coalition has surveyed the investment bankers involved in this program, and the consensus is that it would have to be created within qualified pension funds. Are qualified pension funds currently taxable? No; they are not. Income therein is not taxed currently, and no tax thereon will be paid until the individual pensioners pay taxes on the growth in their proportionate share of the fund when they begin receiving their pensions. At best, the Federal Treasury gets tax deferral, on the average more than 20 years into the future. Thus, when OMB and Treasury thought they were going to capture tax dollars by making these bonds taxable, they have not captured those tax dollars because the purchasers of these bonds, the qualified pension plans, are themselves tax-exempt.

Mr. Chairman, in summary on this point, it can be said that both OMB and Treasury objectives have been defeated by reality; that the desired consequences of the changes they sought have been overturned by consequences unforeseen at the time of their adoption. If they stick with these changes, it will be for naught in terms of benefits derived by the Federal Government and its Treasury, while destroying small businesses in the meantime.

This is clear and convincing evidence that OMB and Treasury ought to reverse their positions and allow this program to return to its configuration prior to their attacks upon it.

The issues before this Committee today are (1) whether this program, under the twin OMB strangleholds of $150 million in annual authority and no guaranteeing of tax-exempt bonds, will survive in any real, viable way, and if it does not, (2) whether small businesses which rely on it under the same conditions and as a "last resort" will then survive.

It should be noted here that, if the law is followed, this SBA program will constitute $250 million or approximately fourteen-hundredths of one percent (0.0014%) of total Government guarantees in FY82, while if the OMB apportionment of $150 million is followed, it will constitute only five-hundredths of one percent (0.0005%).

Why is the Administration So Concerned?

Why is the Administration, principally OMB and the Department of the Treasury, so concerned about this program?

We do not believe that they are. Frankly, we believe that those persons making the decisions know virtually nothing about this program. At best, all they know is that it is one which, for them, conveniently fits into a Federal loan and credit guarantee pigeonhole on one hand and a potential tax revenue losses pigeonhole on the other. One of the biggest problems we have had in trying to resolve this matter is this lack of knowledge and the inaccessibility to us of these persons in order that they might first learn about the program and what's counterproductive in their proposed solutions and then resolve the matter.

The two issues within the debate which OMB and Treasury have created -- Federal guarantees' effects on capital markets and potential tax revenue losses -- deserve separate attention.

Let me first address Federal guarantees and the supposed intrusion into the capital marketplace created by these particular guarantees.

It should be noted that the Federal Government's intrusion in the capital marketplace is not only by Federal credit and loan guarantees but also by its own borrowing for its own public debt purposes. The Administration is rightly concerned about any additional component of its crowding out of available capital. However, many persons are left with the impression that the Administration's "crunch" on the credit and loan guarantee side is of greater interest to it than its concerns on the deficit borrowing side. One could even make a credible argument that the loan and credit guarantee "crunch" is a direct product of the Federal Government trying to offset indirectly the additional impact of its own borrowing and that by doing so it puts the burden of reducing the total Federal Government crowding out on the backs of the private sector and the productive economy, i.e., private borrowing is disadvantaged in order for public borrowing to be advantaged. What an ironic policy objective within this Administration!

This is no longer speculation. On January 14, 1982, Randal C. Teague, counsel to the Coalition, wrote to the Treasury Assistant Secretary for Domestic Finance, Mr. Roger W. Mehle, setting forth arguments similar to those set forth in this statement and asking Treasury to initiate a thorough review of the application of its broad-reaching policy directives as to Federal guarantees and as to tax-exempt financing within this particular program.

By letter of February 4, Assistant Secretary Mehle responded. In that response is a particularly revealing paragraph:

> "Let me emphasize the reasons this Administration is strongly opposed to Federal guarantees of tax-exempt obligations. Placing the credit of the United States behind an obligation that is exempt from Federal taxation would create a security which would be superior in the market to the direct obligations issued by the U.S. Treasury. The Public Debt Act of 1941 prohibits the Federal Government from issuing tax-exempt obligations directly. It would therefore be contrary to the spirit of that Act to authorize the issuance of tax-exempt securities that are backed by the credit of the Federal Government." (Emphasis added)

Mr. Chairman, some very important comments are in order.

We find it disturbing that the spirit of a 1941 Act is given precedence over the letter of the subsequent Small Business Investment Act of 1976 (Public Law 94-305) and over the legislative history of the Joint Resolution making further continuing appropriations for the fiscal year 1982 (Public Law 97-92). Apparently, Treasury is not familiar with the relevant canons of legislative construction to which its policy would be held in a court of law, to wit: (1) That the letter of the law takes precedence over its spirit and (2) that, when there is conflict between legislative enactments (or legislative intents), the most recent in time takes precedence as the most recent expression of Congress.

One has a feeling that the "spirit" derived from the Public Debt Act of 1941 was sought and found subsequent to the OMB decision in order to justify it, for this "spirit" was not an impediment, with the Department of the Treasury or anywhere else, to the first five years of this program. Further, there really is not any legal or factual basis in this 1941 Act for Secretary Mehle's position.

I assume that he is referring to Section 4(a) of the Public Debt Act of 1941 (Public Law 77-7, 55 Stat. 7, 9), an Act of February 19, 1941 which increased the debt limit of the United States to $65 billion and provided for the Federal taxation of future issues of obligations of the United States, principally First and Second Liberty Bonds, U.S. savings bonds and U.S. Treasury savings certificates. Section 4(a) reads in part:

> "Interest upon, and gain from the sale or other disposition of, obligations issued on or after the effective date of this Act (March 1, 1941) by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted ...."

An examination of the legislative history surrounding this Act and its prohibition against the tax exemption of the obligations in question reveals a clear distinction from the bonds guaranteed until December 31, 1981 by the SBA through its pollution control facilities financing program as to disprove his contention.

The principal impetus behind the 1941 Act was to relieve

Treasury of the likelihood of major tax revenue losses. It had become apparent that the meeting of war expenditures would push the U.S. Government public debt not only beyond the previously authorized ceiling but also beyond the $65 billion ceiling established by this Act and, further, that aggregate interest earned by obligation holders would soon grow dramatically. Although the U.S. entrance into the Second World War was ten months in the future, the U.S. Government was already making heavy expenditures in association with the war in Europe and with general U.S. military preparedness. The 1941 Act, in part, amends the "Act to provide ways and means to meet war expenditures" approved June 13, 1938. However, the matter is deeper than this.

The legislative history is clear that the guiding principle behind the enactment of the prohibition on tax exemption of these 1941 Act obligations was the realization that these obligations produced no tax revenues to offset the tax losses which would occur from tax exemption. That is, these U.S. Government obligations had no offsetting tax revenue gains. The SBA guaranteed bonds, on the other hand, do have offsetting tax revenue gains. They are in the form of Federal corporate taxes paid by the small businesses and Federal individual income taxes paid by their officers and employees, some 250 businesses and 20,000 employees in the history of the program to date. Each time a small business obtains tax-exempt financing and remains in business thereby, revenues are increased in the best case circumstances and maintained in the worst case circumstances. Conversely, the absence of the SBA program would create a high risk of tax revenue losses arising from those businesses closing down and laying off their employees.

There is an arrogance in a way in the assertions made within the Mehle letter which cannot go unmentioned. It must arise from believing that because one has thought of impediments to existing policies that it is the first time anyone has thought of them. These "impediments" have been thought through and by Congress; they have also been rejected. They were fully considered by Congress in its 1975 and 1976 consideration of the legislation which led to the enactment of this SBA program, and those arguments were rejected in the constitutional processes of the formulation of this law, which processes this Administration has sworn to uphold and defend. I call everyone's attention to the text of your House (then Select) Committee on Small Business' 1975 hearings, "SBA Assistance for Agricultural Concerns and to Meet Pollution Control Problems," and the subsequent reports (H. Rpts. 94-519 and 94-115) as proof of this.

The assertion that an SBA guaranteed instrument is "superior in the market to the direct obligations issued by the U.S. Treasury" is a misunderstanding, at best, of the capital marketplace. Isn't $150 million in Federally guaranteed taxable bonds the same level of capital marketplace intrusion as $150 million in Federally guaranteed tax-exempt bonds? How does paying a lower rate of interest make pollution control bonds superior? What about the Government's competition with those bonds from its indirect obligations, especially those of government corporations, e.g., the Tennessee Valley Authority or the Bonneville Power Administration, whose obligations are guaranted and the income from which is tax-exempt? Does anyone suspect that anything other than the faith and credit of the United States stands ultimately behind TVA, Bonneville and similar bonds?

Can the Government of the United States be so concerned about its credit and anticipated FY82 and FY83 borrowing that it believes guaranteed tax-exempt pollution control bonds are marketplace threats to that borrowing and the full faith and credit of the United States? If it is, the hour is later than it has acknowledged or most have suspected.

Lastly, the Administration has failed to recognize a real market distortion as severe as that created by the Federal guarantee. It is the Federal Government's requirement for small business expenditures to meet pollution regulation by the acquisition and installation of generally non-productive assets. As long as this Government's policy on the one hand is to have such pollution control regulation, its policy on the other hand must be to assist businesses without private sector loan alternatives to finance the facilities and equipment required, and this means both the guarantee and the tax-exempt bond.

Mr. Chairman, I ask that Mr. Teague's and Assistant Secretary Mehle's letters, as well as a similar one from OMB

Assistant Director for Economic Policy and Planning, Lawrence A. Kudlow, be incorporated as appendices to this statement.

The New, Taxable Bonds Will End Up Tax-Exempt

As I set forth at the beginning of this testimony, the taxable bonds which OMB and Treasury would have guaranteed by a modified pollution control facilities financing program will still escape current Federal taxation.

There is within our economy no existing market for Federally-guaranteed taxable bonds. There is no market because such an obligation has not yet existed. In order for such Federally-guaranteed taxable bonds to be marketed, there will have to be created within the economy a marketplace for them. That can be done. It is a matter of determining the characteristics of these bonds and then the most likely purchasers of them.

The Coalition has surveyed the investment banking community associated with the program as it existed prior to OMB's and Treasury's attacks upon it. There are several possible markets, but there is agreement that the most probable market for Federally-guaranteed taxable bonds is pension funds. It is that reality which defeats OMB's and Treasury's intentions in prohibiting SBA from guaranteeing tax-exempt bonds, for pension funds are exempt from current Federal income taxation. Thus, they will be paid a higher rate of interest by the small businesses, but they will not have to pay taxes currently on that higher rate.

Actually, from OMB and Treasury's standpoint, it will be worse than before they modified the program. Why? Because the greater interest paid on the bonds by the small businesses will constitute a larger deduction from Federal corporate income taxes. The Treasury coffers will end up with less in them than before OMB and Treasury modified the program in order to get more tax revenue.

The Administration ignores something else. As I have already pointed out, small businesses going out of business will have adverse tax revenue loss and budgetary cost impacts too. Reduced corporate taxes paid and reduced Federal payroll taxes paid on one hand, and increased unemployment and other benefits on the other, the latter adding to pressures on the budget side of fiscal policy. Such economics is not only bad economics; it is also bad politics.

The Administration has also not addressed the inequities involved in its attack on this program. Those inequities include the reality that larger businesses are continuing to use tax-exempted IRB financing for their pollution control facilities and equipment expenditures, unhampered by the restrictions of Revenue Ruling 81-216 or of OMB's apportionment document proviso as to this program. The combined impact of that ruling and that proviso is to deny equal access to the tax-exempted bond market to which larger businesses still have access.

A Context for Resolution of This Issue

The problem facing Coalition is that it faces multiple obstacles.

OMB has the present authority to rescind the December 31, 1981 SBA apportionment document proviso prohibiting the further use of the SBA guarantee authority for guaranteeing tax-exempt bonds. It takes no more to rescind it than it did to attach it - a communiation from OMB to SBA to that effect. The probelem would not end there, however, for the actions of this Committee and Congress could thereafter impair its future.

Under present law, the small business required to install pollution control equipment has two alternatives in pursuing tax exempt financing. First, it can seek to qualify its facilities under Section 103(b)(4) of the Internal Revenue Code as an "exempt facility". Under existing Treasury Regulations, however, this approach requires an analysis of financiable costs which is one of the most complex engineering and legal tasks with which I am familiar. This process typically adds thousands of dollars to the cost of issuance of bonds to finance pollution control facilities. The second alternative available to small businesses is the small issue IDB exemption under Section 103(b)(6) of the Internal Revenue Code. These issues can be qualified for tax exempt financing within the $1 million or $10 million limitations without resort to the difficult and detailed tax analysis to which larger pollution control issues are subjected. The fact that qualifying "exempt facilities" financing is unlimited as to dollar amount is, as a practical matter, irrelevant to small business. Such businesses lack borrowing capacity in excess of the $1 million to $10 million range. Thus, even if exempt facilities financing is retained, the elimination or constriction of the small issue exemption would severely hamper the ability of small business to finance pollution control facilities.

Certain of the Administration's proposals to make changes in IDB legislation would effectively put an end to the ability of small business to obtain affordable financing for pollution control facilities. For example, the requirement that the local government make a contribution or financial commitment to the financed facility creates an obvious problem. Even if state law were to permit such contribution, I doubt that many local communities would allocate limited resources toward the financing of pollution control facilities for small business as opposed to competing for location in the community of new facilities, particularly those of substantial size perceived to offer much greater potential benefits to the community.

The SBA guaranteed loan program for tax exempt financing of pollution control facilities is a matter of survival for many small businesses. It is essential to participants in the program and insignificant to the Treasury. It should be permitted to continue within the framework and intent of the existing legislation.

PROPOSED IDB LEGISLATION - GENERAL OBSERVATIONS

The duration of my experience in the practice of law happens to coincide with the life of Section 103 of the Internal Revenue Code in essentially the form in which it now exists. Based upon my experience, I will briefly take this opportunity to comment on what I perceive to be the criticisms of IDB financing being advanced by the Administration and others in recent months.

"The elimination of IDB financing will immediately restore substantial sums to the Treasury". IDB financing has been for businesses, large and small, during the past two years "the only game in town". During this period of extraordinarily high interest rates, the conventional financing alternative has simply been unavailable. Compared to IDB financing, conventional financing has always been less costly to the borrower in terms of the time and money required to achieve a closing. High interest rates, not the lure of IDB financing at rates of 15% or more, have created the recent anomaly with respect to the use of IDB financing. The elimination of IDB financing without a significant reduction in interest rates would not only fail to restore relatively the use of conventional financing, it would run the risk of closing down business activity to a greater extent than is already the case.

"IDB financing is merely another unnecessary advantage provided to big business". Large businesses have indeed utilized IDB financing. I do not know the extent to which the availability of such financing affects the decisions of large companies on the question of whether or not to carry out a particular expansion. I can, however, cite numerous examples of the use of IDB financing by small, family-owned businesses. In some instances, this financing has enabled small concerns to hold their place in the business community. In other cases, it enabled them to achieve substantial growth as employers and taxpayers. Existing legislation has permitted local financial institutions to provide financing to local business at affordable, tax exempt rates. I believe the proposed changes in IDB legislation would direct the funds held by these financial institutions away from local businesses toward investment in large and more credit-worthy companies.

"Public hearings must be required and a public purpose established for IDB financings". This argument is prominent in the recent Administration proposal. I am puzzled. The law of Ohio and that of other states with which I am familiar require that all proceedings relating to the issuance of bonds be open to the public and that a public purpose be established. Indeed, I have participated in numerous hearings which involved debate over the merits of the issuance of industrial development bonds. In some cases, opponents of a proposed bond issue have prevailed. In addition, existing and proposed Treasury Regulations effectively require control over bond issues by public officials in instances where the issuing authority is not a political subdivision. Existing law permits state and local governments to determine the criteria necessary for the issuance of industrial development bonds. The imposition of a federal standard seems both redundant and unduly restrictive of local autonomy.

"Local government must make a contribution or commitment to the facility financed with tax exempt bonds". This idea poses at least two major problems. First, it runs contrary to existing constitutional and statutory restrictions on the "lending of credit" to private business which exists in most, if not all, of the states. Second, this requirement would tend to make the rich, richer and the poor, poorer. The requirement of a local financial contribution would enable a community with greater financial resources to attract desirable businesses from communities whose circumstances would not permit them to offer such direct incentives. I conclude, therefore, that this element of the Administration proposal is ill-advised.

Summary

The Coalition believes that Congress should direct Treasury and all other entities involved in the administration of tax policy, e.g., OMB, to carry out the intent of existing legislation with respect to the SBA Pollution Control Facilities Financing Guarantee Program. The program is vital for the small businesses which can participate. We believe it preserves and may enhance the collection of tax revenues.

The case for this position is clear. The merits of this program are:

- The program actually makes money for the U.S. Government.
- The program does not make a measurable impact on the operation of the capital markets.
- The program does permit access by small business to those capital markets.

- The program constituted less than 1% of the small IRB issues in FY81 and will be less than 1% in FY82.
- The program has demonstrable public benefits, particularly the abatement and control of pollution.
- The program has one of the smallest administrative staffs on record.
- The program is funded with private sector funds, guaranteed by the Federal Government.

We urge your favorable consideration of the recommendations set forth herein.

STATE OF OHIO
OFFICE OF THE GOVERNOR
COLUMBUS 43215

JAMES A. RHODES
GOVERNOR

March 12, 1982

The Honorable Robert J. Dole
Chairman
Senate Committee on Finance
Washington, D.C. 20510

Dear Senator Dole:

On behalf of the people of Ohio, I call upon your committee and the Congress as a whole to take whatever steps are necessary to reinstate a small but vital federal loan guarantee program that is being destroyed by an arbitrary decision of the Office of Management and Budget.

That program is the one by which the Small Business Administration has guaranteed tax-exempt financing for pollution control facilities. OMB has, by pure executive fiat, ordered that SBA not guarantee any pollution financing except on taxable issues.

The SBA program has been extraordinarily effective in helping small businesses throughout the country to meet federally mandated pollution control at no cost to the federal government. The program has usually entailed the sale of SBA guaranteed bonds which are free from federal income taxation. In Ohio, nineteen companies, employing 1,498 people, have had their pollution control bond issues guaranteed in the total amount of $36,470,000. We believe that many of these businesses would not have been able to finance their compliance with pollution laws in the normal financial markets. The impact on those companies - and employees - from violating those laws could have been tragic.

But that was just the beginning. Twenty-six more Ohio companies, employing 2,127 people, already have been issued inducement resolutions to finance an additional $46,060,000 of pollution control. OMB's policy shift has put their projects in a deep freeze and their futures in jeopardy. And we know of at least sixty to eighty more small businesses in Ohio, employing from 3,000 to 4,000 people, who are in varying stages of the SBA applications process. Without SBA guaranteed tax-free financing, these companies, and many others who don't know yet that they have pollution compliance problems, won't be able to finance mandated compliance.

Senator Robert J. Dole
Page 2
March 12, 1982

Ohio will find itself in the unpalatable position of having to enforce federal pollution laws against Ohio businesses who are violating those laws because of federal policy changes which destroyed their ability to comply. That is bad government!

We hope that you will be able to convince the few individuals in the administration who have decreed this arbitrary change to reverse themselves. But if that does not occur, we ask that you promptly develop legislation to require that the SBA continue to guarantee tax-free pollution control financing at the levels previously recommended by Congress.

Yours very truly,

James A. Rhodes

JAMES A. RHODES
Governor

JAR/tt

The Small Business Coalition for Pollution Control

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January 14, 1982

Hon. Roger W. Mehle, Jr.
Assistant Secretary for Domestic Finance
Department of the Treasury
Washington, D. C. 20220

Re: SBA Pollution Control Facilities Financing Guarantee Program
Taxable vs. Tax-Exempt Bond Issues

Dear Secretary Mehle:

The Small Business Coalition for Pollution Control was organized in 1981 to support the policy objectives of the Administration with respect to small businesses and to represent their interests before the Government in the referenced program. The Coalition has been involved actively in recent months in monitoring negotiations between OMB, Treasury and SBA with respect to the FY82 and proposed FY83 annual authority ceilings for this program and the terms and conditions attached thereto.

As you know, a compromise was reached during the closing hours of FY82 First Quarter, a compromise reached between OMB and SBA, the former with the advice of Treasury on one component of that compromise. The compromise is in two parts: the annual authority ceiling, which will be $150 million in FY82 and FY83, Public Law 97-92 notwithstanding, and the proviso requiring that the FY82 authority not closed as of the approximate date of the compromise and all the FY83 authority be available only for taxable bond issues. Because you have been involved in both the Federal loan and credit guarantees and the IDB tax exemption issues, we felt it particularly important to bring several matters to your attention.

This SBA program came into being for only one reason: small businesses could not obtain commercial financing of the expenditures required to comply with Federal air and water pollution control and solid waste management policies and orders without Federal guarantees of the bonds the proceeds of which are used for such facilities and equipment and without the added attraction within the bond marketplace of the tax-exemption.

These expenditures are compelled by Government policy; in the absence of that policy, the expenditures would not be made and the financing sought. If Federal loan and credit guarantees are a financial marketplace distortion, so too is the Government requirement that essentially non-productive control equipment be installed at great expense.

The tax-exemption of the bonds is compelled by the reality that the absence of that exemption would make the bonds, even aggregated, not marketable. If tax-exempt bonds distort the capital pool, it is because the capital sought is mandated by Government environmental policy. If there is fear, well founded in our opinion, that tax-exempt bond issues cause tax revenue losses at a time when budgetary and monetary policy require reduction of those losses, it must be forever borne in mind in looking at this particular program that those losses are far less than the corporate income tax and personal income tax losses which are occasioned when the small businesses close down because the financing is not available.

This latter point is not an allusion to what might happen. Rather, it is a statement of what has happened. When the Administration put this SBA pollution control facilities financing guarantee program in abeyance in the Spring of 1981, there were better than 100 applicants. Some withdrew their applicants, hoping to persuade the environmental enforcement authorities that it was the same Government which had frustrated these companies abilities to comply with environmental standards. But something else, much more dramatic happened: some of these small businesses went out of business. The Coalition has compiled the names and statistical data on those companies.

Before one rushes to say that those small businesses which went out of business must have, therefore, been so marginal that they would not have survived anyway, reflect on the experiential history of this particular program: in its six years, there has never been a default not recovered by SBA. There have been only two defaults at all. There simply is no other Federal loan or credit guarantee program which has a default rate of less than one-fourth of one percent which has also then recovered all of the defaulted payments.

Our plea to you: to recognize the particular circumstances associated with this particular program, including that history and including why these small businesses need the Federal guarantees and the tax-exemption of the financing bonds, and to then do two things: (1) inform OMB, that is Lawrence Kudlow, that Treasury has no objection to rolling back the proviso requiring the remainder of the FY82 $150 million and all of the FY $150 million be available for only taxable issues, and (2) informing those within Treasury involved in the formulation of the Administration's position on the forthcoming Congressional hearings on industrial development bonds that, irrespective of what broader policies are sought, the tax-exemption for IDBs used for pollution control facilities under either IRC §103(b)(6)(E)-(F) solid waste and air and water pollution control facilities exemption or the IRC §103(b)(6)(A) small issue exemption ought to be preserved. We reference IRC §103(b)(6)(A) small issue exemption because a private sector business must use that exemption, rather than either IRC §103(b)(6)(E) or (F) because the latter must be for public purpose and other tests which a private corporation cannot meet. The entire history of this SBA program has been one of using bonds under IRC §103(b)(6)(A).

The difference which taxable bond issues and tax-exempt bond issues have on these small businesses has been set forth in a recent letter to us from H. Robert Fuller of the First Wisconsin National Bank in Milwaukee, one of the four principal financial institutions involved in this program. The other three are Bank of America, Blythe Eastman out of the San Francisco office and McDonald & Co. investment bankers in Cleveland.

My only quarrel with the First Wisconsin depiction of the financial implications of the alternative between taxable and tax-exempt is that the applicants with which we are working indicate that the differential is closer to 4.25%, some 425 basis points.

Your attention to this matter and your involvement in its resolution would be very much appreciated.

Sincerely,

Randal C. Teague

RCT:ms
Enc.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

February 4, 1982

Dear Mr. Teague:

I am pleased to respond to your letter regarding the SBA pollution control facilities guarantee program.

In the last decade, rapid growth of Federal credit activity has had serious effects on the Nation's economy and on financial markets. For this reason, rigorous control over Federal credit programs has been and continues to be an important part of the President's budget reform plan. Greater control of these Federal programs is being accomplished by reducing their size and scope and by adopting legislative and administrative actions to decrease their impact on the capital markets.

In this regard, the Administration has maintained strong opposition to Federal guarantees of tax-exempt obligations, such as those obligations issued in conjunction with the SBA pollution control guarantee program. In a March 23, 1981 message to Congress, the President expressed his general opposition to federally-guaranteed tax-exempt obligations and the April 1981 "Additional Details on Budget Savings" specifically criticized the SBA pollution control guarantee program in this regard. The decision reached by OMB to only provide loan guarantees under the SBA pollution control program for taxable bond issues in fiscal years 1982 and 1983 results from this position.

Let me emphasize the reasons this Administration is strongly opposed to Federal guarantees of tax-exempt obligations. Placing the credit of the United States behind an obligation that is exempt from Federal taxation would create a security which would be superior in the market to the direct obligations issued by the U.S. Treasury. The Public Debt Act of 1941 prohibits the Federal Government from issuing tax-exempt obligations directly. It would therefore be contrary to the spirit of that Act to authorize the issuance of tax-exempt securities that are backed by the credit of the Federal Government.

Moreover, since the tax loss to the Treasury greatly exceeds the interest savings to the issuer of tax-exempt obligations, Federal guarantees of tax-exempts are a most inefficient means of providing Federal assistance.

The Administration is also concerned with the adverse effects of tax-exempt guarantees on the municipal market. Federal guarantees of tax-exempts create a security which is superior to all other tax-exempt securities issued by State and local government entities. Consequently, such guarantees add to the pressures on the municipal bond market, crowd out other, less creditworthy municipal borrowers, and increase the borrowing costs of all municipal borrowers.

I hope this information is helpful.

Sincerely,

Roger W. Mehle

Roger W. Mehle

Mr. Randal C. Teague
Vorys Sater Seymour & Pease
1828 L Street, N.W.
Washington, D.C. 20036

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

February 18, 1982

Mr. Randal C. Teague
Vorys, Sater, Seymour & Pease
1828 L Street, N.W. - Suite 1111
Washington, D.C. 20036

Dear Mr. Teague:

This is in response to your letter to Craig Fuller and me expressing the concerns of your clients about the Administration's policies regarding the Pollution Control Equipment Contract Guarantee Revolving Fund of the Small Business Administration (SBA).

As you indicate in your letter, a decision has been made to permit the guarantee of $150 million in pollution control loan or contract repayments during 1982. This decision, which results in a 1982 program level that is 50% higher than the 1981 actual level, was made with two caveats:

— First, that in view of the President's efforts to constrain Federal borrowing, the increase in guarantee authority for the pollution control program would be offset by a comparable reduction in other SBA credit programs.

— Second, that in view of the Administration's opposition to indirect Federal guarantee of tax-exempt bonds, the guarantees of repayments would be limited to loans or contracts that are financed from the proceeds of taxable bonds.

With respect to your allegation that this decision constitutes a violation of the law, I must strongly disagree. The Second Continuing Resolution for Fiscal Year 1982 (P.L. 97-92) did not "lock in" a $250 million program level for this Fund. In fact, the resolution did not provide statutory credit limitations for any of the SBA loan programs.

With respect to your concerns about the effect of the decision to discontinue the guarantee of loans financed from the proceeds of tax-exempt securities, I must also disagree. The combination of Federal guarantees with tax-exempt bonds increases the revenue loss to the U.S. Government while primarily benefiting the high-income purchasers of the bonds rather than small businesses. In addition, the Federal guarantee adds to the pressures on the municipal bond market by creating a security that is superior to all other tax-exempt securities issued by State and local governments. This could result in higher borrowing costs for State and local governments, which must finance schools, roads, hospitals, and other essential public facilities.

This Administration is continuing its efforts to alleviate Federal regulatory burdens that contribute to the high costs of operating small businesses. Where such regulations are necessary, we are attempting to ensure small business access to capital to comply with such requirements.

I hope that this response provides sufficient information for you to explain to your clients the reasons for the Administration's policies. Thank you for sharing their concerns.

Sincerely,

Lawrence A. Kudlow
Associate Director for
Economic Policy and Planning

cc: Craig Fuller

The Small Business Coalition for Pollution Control

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February 12, 1982

The President of the United States
The White House
Washington, D.C. 20500

Dear Mr. President:

We are small businesses whose abilities to provide jobs, produce goods and services, pay taxes and protect the environment have been consciously undermined in recent months by your Office Of Management and Budget's virtual destruction of the Small Business Administration's pollution control facilities and equipment financing guarantee program.

This letter is an urgent plea that you direct OMB to withdraw the unnecessary and probably illegal requirement it attached to the recent SBA apportionment document - that none of the remaining FY83 authority can be used to guarantee tax-exempt bonds. Those are the only bonds really available in the marketplace for financing these facilities and equipment.

Experts in this financial field are convinced that "taxable only" financing will effectively destroy the ability of numerous small businesses to finance compliance with government mandated pollution laws.

There is a profound inconsistency in the Government's administration of its environmental laws, and we are the small businesses caught in the middle of that inconsistency. On the one hand, we are being required to install environmental protection facilities and equipment to meet still-stringent EPA rules, and on the other hand, the OMB requirements eliminate the only effective means of obtaining loans required to install those facilities and equipment. Without this SBA program of "last resort" small businesses will be forced into noncompliance with environmental protection statutes, regulations, plans and orders. Or, into forced sales to bigger businesses with larger assets and borrowing leverage. Or, into insolvency if forced to overleverage against usually low net worth, because the uniqueness of these facilities and equipment leaves them without significant collateral values. Or, into shutdown.

We measure those dire, yet realistic, consequences against the experience of this program, SBA's most successful. It is that success which shows the lack of knowledge or interest at OMB.

No one in business knows the adverse impacts of the Federal Government spending and taxing and over-regulating more than a small business. Small businesses are the first hit by inflation. They are the first hit by crowding out and high interest rates. They are usually the first into economic slumps and the last out. This is why most small businesses, including those within the Small Business Coalition for Pollution Control, support your economic program of reduced spending, reduced corporate and individual income taxes, and reduced deficits. We support your attack on the crowding out of available capital and the inflationary pressures those deficits can create. We, too, seek reduced regulation and expanded export opportunities. But, OMB's broad policy objectives produce unintended consequences when applied to this SBA program.

OMB contends that the annual authority for this program must be rolled back to reduce Federal loan and credit guarantees in the capital marketplace. OMB contends, further, that the requirement prohibiting the program's association with tax-exempt bonds is necessary to prevent tax revenue losses.

OMB is wrong. This program constituted less than one percent of the small industrial revenue bond issues in 1981. It does not interfere with markets. The program has a nearly pristine actuarial integrity, with the only two defaults in its history now being recovered by SBA. The program actually makes money for the Government; its initial $15 million revolving fund has grown to over $30 million by the accumulation of the 3.5% fees paid by the applicants, and interest on that fund more than pays for all administrative costs. The program is funded with private sector funds; it is only guaranteed by the Government. The program has public benefits, particularly pollution abatement. Most importantly of all, it has benefited small businesses in more than 30 States, representing more than 20,000 jobs. If continued, the program will benefit many thousands more.

Mr. President, the "distortion" this program creates in the financial marketplace is miniscule compared to the real distortion caused by the Government requiring us to spend hundreds of millions of dollars on essentially non-productive facilities and equipment. Further, the tax revenue losses from tax-exempt IRBs are miniscule compared to the real tax revenue losses which will result if we have to close our businesses and lay off our employees. Or, if we can't expand productive capacity. Absent a continuation of this program, as it existed prior to OMB's attacks upon it, that may happen to many of us. Bonds for our purposes simply cannot be marketed in the absence of the tax-exemption and the Federal guarantee.

Our case is clear. The merits of this program speak for themselves.

We ask you to direct OMB to reverse its unilateral actions and to do so before the matter worsens.

Respectfully requested,

Jack L Schaefer

Jack L. Schaefer
THE SPECIALTY PAPERS COMPANY
Dayton, Ohio

Steve Milter
NATIONAL BRIQUETTE CORPORATION
East Chicago, Indiana

Robert E. Embry
Baum Gardener Oil, Inc.
ENERGY RESOURCES,LTD.
Baltimore, Maryland

Robert Speach
ENV, INC.
Long Beach, California

James D. Lightbody
PHILWAY, INC.
Ashland, Ohio

Frank E. Smith
F. E. SMITH CASTINGS, INC
Kingsford, Michigan

Fred Davino
PLATING FOR ELECTRONICS, INC.
Waltham, Massachusetts

Carl Hornby
ENVIRONMENTAL WASTE CONTROL,
INC.
Inskster, Michigan

Craig Caine
AMERICAN FLY ASH COMPANY
Des Plaines, Illinois

Dennis O'Meara
OMEGA CHEMICAL CORPORATION
Whittier, California

Les A. Liman
DOWNHILL PICK-UP
Steamboat Springs, Colorado

J. E. Droege
ELECTROFILM, INC.
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Anthony L. Torrance
OPTICAL SCIENCES GROUP
Petaluma, California

Aubrey Burer
CHEMTRONICS
El Cajon, California

Larry Winget
Gary L. Robbins
VENTURE INDUSTRIES CORPORATION
Fraser, Michigan

W. O. Larson
M. F. Ludowese
LARSON CONSOLIDATED, INC.
Grafton, Ohio

Lewis Lakin
A. LAKIN & SONS, INC.
Chicago, Illinois

Harvey Scholten
RIVULET HURST DAIRY
Holland, Michigan

Leroy Wurst
HURON CASTINGS COMPANY
Pigeon, Michigan

Paul J. Keating
John A. DelRossi
P. J. KEATING COMPANY
Fitchburg, Massachusetts

Donald Schulz
NATIONAL METAL FINISHING COMPANY
Springfield, Massachusetts

The CHAIRMAN. We've got a problem. I'm needed for a quorum down the hall. They have 9 and they need 10. I am trying to draft another Senator to come to this meeting. Not that these hearings aren't exciting. [Laughter.]

They are otherwise occupied.

Let's go ahead, Mr. Bean. We will do as much as we can. We may have to have a little short recess here while I run down there.

STATEMENT OF RONALD BEAN, PRESIDENT, COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES, WASHINGTON, D.C.

Mr. BEAN. Thank you, Senator. I am Ronald Bean. I'm the president of the Council of Pollution Control Financing Agencies, and also the director of the Illinois Pollution Control Financing Authority. And I would just ask that our statement be submitted for the record.

I would summarize by saying that the general purpose of IDB's is to encourage socially productive undertakings and there is not more socially productive undertaking than the protection of the environmental quality of life.

To that end, I believe that the records will show this. I know that in the State of Illinois that roughly 50 percent of the pollution control bonds have been used by the public utilities. The reduction or change in the legislation that enables the utilities to use this as a means of installing pollution control equipment, would mean that the increased cost of financing would flow down to those who are least able to bear the brunt of increased costs. That is, the ultimate consumer, many of whom have been battered this winter by high utility costs.

The other point that I would make in summary is that the use of IDB's for pollution control should be as cost effective as possible. Dr. Rivlin of the CBO has mentioned that to target these pollution control bonds for pollution abatement as well as pollution control would be to reduce the cost of the use of this facility for pollution control and pollution abatement purposes.

Because of brevity, I will say no more at this point. I think that these are the points that I would like to get across at this time.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Bean follows:]

COUNCIL OF
POLLUTION CONTROL FINANCING AGENCIES

STATEMENT

Presented to
The Senate Finance Committee
March 17, 1982

On behalf of The Council of Pollution
Control Financing Agencies

by

Ronald Bean
Appearing as President
The Council of Pollution Control Financing Agencies
and
Executive Director
Illinois Environmental Facilities Financing Authority

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MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, I AM RONALD BEAN, EXECUTIVE DIRECTOR OF THE ILLINOIS ENVIRONMENTAL FACILITIES FINANCING AUTHORITY. I APPEAR BEFORE THIS COMMITTEE AS PRESIDENT OF THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES. ON BEHALF OF THE COUNCIL, I WELCOME THIS OPPORTUNITY TO PROVIDE THE COMMITTEE WITH OUR VIEWS REGARDING CURRENT PROPOSALS TO MODIFY TAX-EXEMPT FINANCING OF POLLUTION CONTROL FACILITIES.

MR. CHAIRMAN, THE ADMINISTRATION'S RECENT PROPOSAL TO RESTRICT THE AVAILABILITY OF IDBS FOR POLLUTION CONTROL FINANCING WILL RESULT IN DEVASTATING CONSEQUENCES FOR SMALL AND MEDIUM SIZED BUSINESSES AND THE NATION'S PROGRESS TOWARD INCREASED ENVIRONMENTAL QUALITY OF LIFE. SIMPLY PUT, THESE BUSINESSES CANNOT AFFORD THE POLLUTION CONTROL EQUIPMENT MANDATED BY FEDERAL/STATE/LOCAL LAWS AND REGULATIONS, WITHOUT THE UNRESTRICTED AVAILABILITY OF TAX-EXEMPT POLLUTION CONTROL FINANCING. THIS IS ESPECIALLY THE CASE WITH REAL INTEREST RATES HOVERING AT THE 18% LEVEL.

THE ADMINISTRATION'S PLAN TO RAISE ADDITIONAL REVENUES INCLUDES A PROPOSAL TO CURTAIL THE AVAILABILITY OF TAX-EXEMPT BONDS FOR POLLUTION CONTROL FACILITIES. THE ADMINISTRATION ARGUES THAT TAX-EXEMPT FINANCING SERVES A QUASI-PUBLIC PURPOSE, THUS CREATING UNDUE COMPETITION IN FINANCING OTHER MUNICIPAL SERVICES. RESTRICTING THE AVAILABILITY OF POLLUTION CONTROL FINANCING, IT IS POINTED OUT, WILL LESSEN THIS COMPETITION. THE COUNCIL BELIEVES THIS REASONING FAILS TO CONSIDER A KEY POINT. THESE BONDS FINANCE THE PURCHASE OF POLLUTION CONTROL FACILITIES MANDATED BY THE CLEAN WATER, CLEAN AIR AND THE RESOURCE CONSERVATION AND RECOVERY ACTS. THESE ACTS, I MUST POINT OUT, WERE IMPLEMENTED DURING THE LATTER PART OF THE SEVENTIES, WHICH ACCOUNTS FOR THE GROWTH IN THE USE OF THESE BONDS. THE PUBLIC, IN OVERWHELMING MAJORITIES AS ILLUSTRATED IN NUMEROUS SURVEYS, SUPPORTS THESE LAWS AND THEIR OBJECTIVES. IN SHORT, TAX-EXEMPTS FINANCE A PUBLIC GOAL--CLEAN AIR, WATER, AND LAND.

THE ADMINISTRATION FURTHER POSITS AND I QUOTE FROM ITS EXPLANATION OF THE TAX PROPOSAL:

> "...BUSINESSES REQUIRING POLLUTION CONTROL FACILITIES, THROUGH THE USE OF TAX-EXEMPT FINANCING CREATES A BIAS IN FAVOR OF INVESTMENT OF THOSE ACTIVITIES. IN EFFECT, THOSE FAVORED ACTIVITIES FOR EXAMPLE, BUSINESSES THAT CREATE POLLUTION, ARE SUBSIDIZED AT THE EXPENSE OF OTHER ACTIVITIES."

MR. CHAIRMAN, THOSE INVESTMENTS ARE MANDATED BY STATUTE AT THE FEDERAL, STATE, AND LOCAL LEVELS OF GOVERNMENT. IT IS INCUMBENT UPON THOSE WHO MANDATE THESE INVESTMENTS TO PROVIDE THE MEANS TO REACH THE DESIRED END OF A CLEANER ENVIRONMENT. IN THIS CASE WE ARE SPEAKING OF THE UNRESTRICTED USE OF TAX-EXEMPT POLLUTION CONTROL FINANCING THAT ENCOURAGES COMPLIANCE WITH ENVIRONMENTAL REGULATIONS.

THE ADMINISTRATION ALSO IS CONCERNED ABOUT DOUBLE DIPPING BENEFITS A BUSINESS RECEIVES USING BOTH ACRS AND TAX-EXEMPT FINANCING FOR POLLUTION CONTROL. THE ADMINISTRATION BELIEVES THIS ADVANTAGE IS UNWARRANTED. THIS IS A PHILOSOPHICAL ISSUE WHICH IS SUBJECT TO DEBATE. HOWEVER, WE ARE WORKING WITH REAL LIFE SITUATIONS. THE DENIAL OR RESTRICTION OF TAX-EXEMPT FINANCING MEANS WE HAMPER ANY HOPES OF SUSTAINED ECONOMIC RECOVERY FOR SMALL AND MEDIUM SIZED BUSINESSES BECAUSE PLANT EXPANSION AND MODERNIZATION REQUIRE ACCESS TO AFFORDABLE CAPITAL FOR THE UNPRODUCTIVE COSTS OF POLLUTION CONTROL FACILITIES. THIS IS ONLY AVAILABLE THROUGH TAX-EXEMPT FINANCING.

THERE WILL ALSO BE AN ENVIRONMENTAL CONSEQUENCE. THE LACK OF ADEQUATE POLLUTION CONTROL FINANCING MEANS INADEQUATE POLLUTION CONTROL FACILITIES LEADING TO NON-COMPLIANCE OF ENVIRONMENTAL MANDATES. ULTIMATELY, THIS WILL LEAD TO A DECREASED QUALITY OF LIFE.

THE ADMINISTRATION ALSO CITES REVENUE LOSSES THE GOVERNMENT INCURS FROM TAX-EXEMPT FINANCING OF POLLUTION CONTROL FACILITIES AS ANOTHER REASON TO RESTRICT THIS FINANCING. THE COUNCIL BELIEVES THIS PREMISE TO BE ERRONEOUS. AS BUSINESSES SHUT-DOWN BECAUSE OF A LACK OF FINANCING, REVENUES FROM PAYROLL AND CORPORATE TAXES DECREASE AND THE PRODUCTIVITY OF THE NATION DIMINISHES, THEREBY INCREASING REVENUE LOSS. DENIAL OR RESTRICTION OF TAX-EXEMPTS ACUTALLY MEANS HIGHER PRICES, LOWER LEVELS OF PRODUCTIVITY, AND POSSIBLY HIGHER UNEMPLOYMENT. ALSO, ELECTRIC UTILITIES REQUIRED TO INSTALL MILLIONS OF DOLLARS WORTH OF POLLUTION CONTROL FACILITIES THAT ARE DENIED ACCESS TO UNRESTRICTED POLLUTION CONTROL FINANCING WILL HAVE ONLY ONE RECOURSE. UTILITIES WILL BE FORCED TO INCREASE CONSUMER UTILITY RATES TO OFFSET INCREASED FINANCING COSTS OF POLLUTION CONTROL FACILITIES. THIS WILL SERVE ONLY TO EXACERBATE CURRENT ADVERSE ECONOMIC CONDITIONS. THE PROPOSAL WORKS TO THE DETRIMENT OF A SUSTAINED ECONOMIC RECOVERY BECAUSE IT STYMIES BUSINESS EXPANSION, AN INTEGRAL PART OF WHICH INCLUDES POLLUTION CONTROL FACILITIES.

THE ADMINISTRATION ALSO PROPOSES TO REQUIRE GOVERNMENTAL UNITS TO MAKE A ONE PERCENT COMMITMENT EQUAL TO THE BOND'S FACE VALUE IN CASH OR IN KIND. OR IT CAN ELECT TO GUARANTEE OR INSURE THE BOND. THIS IS NOTHING BUT AN ATTEMPT TO SHORT CIRCUIT THE USE OF TAX-EXEMPT FINANCING. FIRST, ONLY THREE STATES HAVE AUTHORITY TO PROVIDE A GUARANTEE. SECOND, UNDER ANY "NEW FEDERALISM", STATES AND LOCALITIES

WILL ASSUME THE INCREASED COST OF FINANCING ADDITIONAL SERVICES, AND THEIR ABILITY TO DO SO IS DOUBTFUL AS DETERIORATING INFRA-STRUCTURES WILL DEMAND THE COMMITMENT OF SCARCE STATE AND LOCAL RESOURCES. AND THIRD, MOST STATES AND LOCALITIES ARE LIMITED CONSTITUTIONALLY OR STATUTORILY TO THE AMOUNT OF DEBT THEY CAN INCUR. IF YOU ACCEPT THIS PROPOSAL, THE FEDERAL GOVERNMENT IS DEMANDING WE TAKE ON GREATER FINANCIAL RESPONSIBLITIES WHILE, AT THE SAME TIME, SEEKING TO REMOVE THE TOOLS REQUIRED TO ACCOMPLISH THESE ADDITIONAL DUTIES.

WE WELCOME THIS REEXAMINATION OF FEDERAL/STATE/LOCAL ROLES, BUT ONLY SO LONG AS ADEQUATE TOOLS ARE AVAILABLE TO FACILITATE AN ORDERLY AND EFFECTIVE RESTRUCTURING OF RESPONSIBILITIES OVER THE LONG-TERM. TAX-EXEMPT POLLUTION CONTROL BONDS ARE ONE SUCH TOOL--AND A CRITICAL ONE AT THAT--TO ENHANCE ECONOMIC RECOVERY AND ENSURE ENVIRONMENTAL INTEGRITY.

FOR THE RECORD, I AM ATTACHING FURTHER INFORMATION RELATING TO THE ADMINISTRATION'S PROPOSAL AS WELL AS THE IMPORTANCE OF THE CONTINUED NEED FOR SBA POLLUTION CONTROL LOAN GUARANTEES. I AM ALSO ATTACHING MATERIAL SUPPORTING THE EXPANSION OF CURRENT AUTHORITY TO INCLUDE THE FINANCING OF HAZARDOUS WASTE FACILITIES.

MR. CHAIRMAN, THIS CONCLUDES MY FORMAL TESTIMONY. I WOULD BE HAPPY TO RESPOND TO ANY QUESTIONS THE COMMITTEE MAY HAVE AT THIS TIME.

EXHIBIT A

SUPPORTIVE DATA

1. Sections 103(b)(4)(E) and (F) of the Internal Revenue Code provide the only meaningful tax incentive in the Code for the acquisition of solid waste disposal or air or water pollution control facilities. Unfortunately the availability of tax exempt financing is restricted under proposed Treasury regulations which, notwithstanding EPA's objections, define pollution control facilities as only those devices that operate at the end of the production process. The rule is that any system that eliminates the creation of pollution is not for air or water pollution control. This "realized pollution" test disregards the fact that state or local governmental units and corporate citizens are designing nonproductive pollution control facilities pursuant to EPA mandate and modern technology. Further the regulations are contrary to the standards required for treating hazardous waste under RCRA.

2. The Council of Pollution Control Financing Agencies, as well as EPA, has concluded that the Service's interpretations are counter productive to the nation's environmental and energy policies. Since Treasury and the Service have ignored all requests for change, Congress must enact technical amendments to Section 103(b) that will insure tax exempt financing for companies and local government units which acquire pollution control and/or solid waste disposal facilities.

3. Since 1970, governmental units and corporations, in an effort to support the nation's environmental and energy goals have spent billions of dollars for air and water pollution control and the treatment of solid wastes. These expenses will continue into the 1980's, particularly because of the treatment of hazardous wastes required under RCRA.

4. Since the Treasury regulations do not recognize the treatment of hazardous waste as being for the control of air or water pollution or solid waste, such expenditures are denied, arbitrarily, the benefits of tax exempt financing. Further, since all potential polluters are adopting technology for eliminating pollution rather than designing facilities that operate on pollutants at the end of a pipe, they are precluded from fully utilizing Section 103(b)(4)(F). This denial is unfair -- the tax incentive already exists -- and adds to the costly burden of acquiring nonproductive assets.

5. The proposed regulations penalize governmental units and corporations for being good citizens.

6. Congress should enact technical amendments to Sections 103(b)(4)(E) and (F) to guarantee that those who comply with the nation's environmental and energy standards will obtain the existing statutory tax incentives.

Introduction

The Council of Pollution Control Financing Agencies is a Section 501(c)(3) organization devoted toward the education of the public through an annual symposium, workshop programs and publications of the nation's environmental standards including analyses of regulatory actions. Its voting members are state or local government agencies charged with aiding either state or local government units or companies in financing their environmental compliance programs. Attached hereto as Exhibit A is a more complete description of the Council.

Its non-voting members consist of public members such as investment bankers, law firms and companies. This broad based membership has allowed the Council to establish a liaison with officials with policy responsibilities affecting pollution control financing at the Environmental Protection Agency, Council on Environmental Quality, Treasury Department, Securities and Exchange Commission, and Small Business Administration.

The combination of Council policy and membership affords the Council a unique position within our system. It is from this broad base of experience that the Council has learned of a serious problem relating to pollution control financing caused by the Internal Revenue Service and proposed Treasury Regulations. Further, the Council believes the harmful effects of the regulations will be exacerbated by reason of the need for compliance under RCRA. Accordingly, the Council appears before this Committee to suggest that it act immediately to clarify Sections 103(b)(4)(E) and (F) as discussed below. Since the Service and Treasury have ignored both EPA and the Council's comments that the regulations are contrary to Congressional intent, inconsistent with national environmental and energy policies and detrimental to both state and local governmental agencies charged with financing environmental protection systems and companies efforts to finance nonproductive facilities, Congress must intervene.

Present Law

Industrial development bonds, i.e., bonds defined in Section 103(b) of the Code as being issued by or on behalf of states or their political subdivisions for the benefit of private businesses, generally do not bear tax exempt interest under Section 103(a). However, where the proceeds of the bonds will be used for certain "exempt activities" (e.g., air or water pollution control facilities, solid waste disposal facilities, etc.) the bonds will bear tax exempt interest.

Realized Pollution Test

The Treasury and the Internal Revenue Service have promulgated and proposed various definitions of the types of facilities that may be regarded as being pollution control and solid waste disposal facilities. Many of these rules so narrowly restrict the types of facilities qualifying for tax exempt bond financing that they are contrary to the underlying statute and to some of the policies of the EPA.

In particular, Proposed Reg.§§1.103-8(g)(2)(ii), (iii) and (iv) adopt a "realized pollution" test. This test holds that facilities which prevent pollution are not for the control of pollution. Thus only "end of pipe devices" qualify for tax exempt financing. Excluded by the regulatory definition of air or water pollution control are such facilities, even if acquired pursuant to EPA mandate under the Clean Air Act, the Federal Water Pollution Control Act, or RCRA, that treat hazardous waste, eliminate the creation of a pollutant through process changes, control a "nuisance", or are used "traditionally or customarily" by an industry. This interpretation belies Congressional intent and is at odds with the modern methods of pollution control which are being developed by industry in cooperation with the EPA.

The law permitting tax exempt financing of pollution control and solid waste disposal facilities was enacted in 1968 to encourage the installation of such facilities. Such equipment is frequently placed in service because public policy demands that the environment be protected even though this may require investment that either is unprofitable for a producer or involves a high degree of financial risk. The Service's failure to give proper recognition to these facts is philosophically unfair and statutorily improper.

Gross Savings Test

Assuming the facility meets the so-called "realized pollution test", the position of the Internal Revenue Service is that the allowable amount of financing for a pollution control facility is its cost reduced by the value of any recovered useful by-product, or the value of any form of "gross" economic benefit to the manufacturer.

Proposed Reg §1.103-8(g)(3) guarantees a reduction in allowable financing even where off-setting costs of operation associated with a pollution control device equal or exceed the alleged benefits. This formula is inconsistent with EPA guidelines, contrary to standard accounting methods, and legally arbitrary.

Hazardous Waste

As stated earlier, facilities which treat hazardous wastes fail to meet the realized pollution test and accordingly do not qualify as an air or waste pollution control facility under Section 103(b)(4)(F). Even if such devices are acquired pursuant to the Solid Waste Disposal Act, the Treasury regulations deny tax exempt financing under Section 103(b)(4)(E).

In the case of the exemption for solid waste disposal facilities, the term "solid waste" has been defined by the Internal Revenue Service to mean solid waste within the meaning of the Solid Waste Disposal Act as it existed in 1968, despite the fact that the Act has been amended to modernize the government's response to the problem of solid waste disposal. Thus, for example, solid waste disposal facilities as defined and mandated by Congress in RCRA are excluded from qualifying for tax-exempt financing.

Congress Must Act

Proposed Bill or Amendment

The Committee should pass a bill or an amendment, the purpose of which would be to clarify the meaning of the terms "solid waste" and "pollution control" for purposes of Sections 103(b)(4)(E) and (F). It should be clear that the Committee believes that the Treasury and Internal Revenue Service's interpretations are too restrictive and that a reasonable definition of those terms was intended by the Congress when it originally enacted Section 103(b)(4). Further, the Committee should make it clear that artificially narrow definitions do not promote the legislative purpose of the provision, i.e., to encourage pollution control and solid waste disposal.

The definition of pollution control facilities should include any facility that is installed, in whole or in part, for the purpose of abating, controlling or preventing water or atmospheric pollution so long as a certification to that effect is given by a responsible local, state or Federal environmental agency. The effect of such a provision would be to ensure that environmental agencies have the authority to determine whether or not tax incentives are consistent with overall environmental policy. Thus, statutorily, the prevention of pollution is the same as the control of pollution.

In order to guarantee that only the portion of the cost of pollution control facilities which are not recouped by net economic benefits is eligible for financing, the bill could provide for a reduction in costs eligible for financing to the extent of net economic benefits. No such reduction should be made, however, where the facility is installed primarily for pollution control. Thus, the bill should provide a conclusive presumption that the entire cost of a facility qualifies for tax-exempt financing if the facility would not have been installed but for pollution control purposes.

In the case of solid waste disposal facilities, the bill should contain the provisions of present law which recognize and encourage economic solid waste disposal, including resource recovery and profit-making recycling. However, the bill clarifying the definition of solid waste can be accomplished so that it is the same definition of "solid waste" that is contained in The Solid Waste Disposal Act as amended. This provision will negate the unrealistic idea that the definition of solid waste under Section 103 of the Code is to remain frozen to 1968. Solid waste disposal facilities under Section 103 reflect changing environmental policy. Thus, for example, the bill should include hazardous waste within the definition of solid waste.

Conclusion

The Council of Pollution Control Financing Agencies, as well as many taxpayers, and the EPA have advised the Treasury and Internal Revenue Service that its regulations are legally arbitrary and inconsistent with the Nation's environmental and energy goals. Since these comments have not been repudiated i.e., they have been totally ignored, Congress must amend Sections 103(b)(4)(E) & (F) to guarantee that environmental judgments can be made by those entities capable of ascertaining most intelligent environmental policy without prejudicing governmental units or companies tax rights.

EXHIBIT B

COUNCIL OF
POLLUTION CONTROL FINANCING AGENCIES

January 21, 1982

The President
The White House
Washington, D.C. 20500

Mr. President:

We are most concerned about reports that the Administration intends to limit the use of tax-exempt industrial development bonds (IDBs) to finance pollution control facilities. As a coalition of organizations whose members rely upon this form of financing, we believe attempts to restrict the availability of IDBs for pollution control would adversely affect your efforts to foster economic growth in America and reduce environmental pollution. We urge the Administration not to restrict the use of IDBs for pollution control financing. Furthermore, we believe the current availability of IDBs for pollution control should be expanded to include, as specifically eligible for tax-exempt financing, hazardous waste facilities.

American businesses, large and small, depend upon IDBs to meet requirements under Federal and State environmental law. Pollution control facilities, such as stack scrubbers to control sulphur dioxide and other preventive technologies, unfortunately yield no returns to business. But they are critical in achieving mandated environmental goals that have strong public support. To meet this worthwhile objective, industry has traditionally used IDBs to decrease the capital costs of control facilities. The use of IDBs for pollution control reduces the costs of facilities, makes more capital available for economically productive purposes, and is thus completely consistent with the goals of your economic recovery program.

Recent reports suggest you have under consideration several options to curtail the availability of IDBs for all purposes. This would have the effect of either eliminating IDBs or offering businesses a choice between IDBs and the recently implemented Accelerated Cost Recovery System (ACRS). Neither option is viable. They cannot foster economic recovery because they fail to acknowledge the limited availability of capital in the private sector and the almost total absence of financing sources of non-productive pollution abatement and prevention facilities.

These two tax provisions are not comparable. ACRS was enacted to unleash the nation's productive capacity. However, IDBs for pollution control are used to lessen the unequal impact on industry of pollution control mandates. They are reducing the additional costs of production and easing a major restraint on economic activity. The denial or restriction of IDBs to industry will mean higher prices or lower levels of productivity, or both. There is no basis for a policy which forces industry to choose between using IDBs for pollution control and using ACRS, which has a different rationale and makes no distinction between pollution control and other uses.

Denial of IDBs for pollution control will be most harmful to small businesses, the main source of new jobs and economic growth. A small firm must shut down if it cannot find reasonable financing to meet its pollution control mandates.

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Also, there will be severe impediments to the development of badly needed joint public/private ventures for disposal of solid and hazardous wastes. The marginal economics of these projects requires tax-exempt financing to avoid having all costs absorbed by hard-pressed local governments, and to permit the participation of private firms in solving this growing environmental problem. Communities are looking for disposal alternatives at the lowest possible cost. Tax benefits passed on to investors result in lower interest rates and reduced disposal costs to the community.

Businesses use small issue tax-exempt obligations to finance hazardous waste control facilities because of the failure of the Internal Revenue Service to reflect the most current statutory definition of solid waste in its regulations. Revenue Ruling 81-216 and subsequent proposed regulations coupled with the uncertain availability of SBA pollution control loan guarantees jeopardizes the continued use of this alternative to finance these needed and legally required facilities. Further, IRS initiatives have failed to take into account Congress' announced intentions to review the use of small issue IDBs for this and other purposes. Congress should have this opportunity.

When used for pollution control purposes, IDBs contribute to the nation's efforts to re-industrialize, to its economic and social vitality, and foster a healthier and safer environment in the process.

Sincerely,

Louis Laun

Louis Laun, President
American Paper Institute

Robert Partridge, General Manager
National Rural Electric Cooperative
Association

Ronald Bean

Ronald Bean, President
Council of Pollution Control
Financing Agencies

Richard L. Hanneman

Richard L. Hanneman, Director of
Government and Public Affairs
National Solid Wastes Management Associ

William McCollam, Jr., President
Edison Electric Institute

Jack L. Schaefer, President
Small Business Coalition for Pollution
Control

William D. Wiggins, President
National Association of Metal
Finishers

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EXHIBIT C

Sidebar:

WASTE BUSINESS GROWS AS LANDFILL CLOSES

The only landfill in Grundy County, Illinois, closed last year. But local scavenger, Mel's Disposal, just kept taking on new customers.

Dave Melhorn even signed up the town of Morris where the landfill had been located.

Melhorn's new transfer station, the first privately-owned one in Illinois, permits him to handle 250-300 tons of solid waste per day and deliver it to the nearest available landfill, now 22 miles away.

Mel's Disposal earns more than $100,000 a month, serving 12,000 homes and 2,000 commercial establishments. Nine years ago, Melhorn and his wife, Kathy, started the business with one pickup truck serving three households, making $9.00 a month. While they had grand plans for their business, it was difficult to secure the financing needed to make their visions real.

- more -

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Reluctant to get involved with government agencies, they nevertheless finally contacted the Illinois Environmental Facilities Financing Authority (IEFFA) which offered financing tailor-made for the Melhorn's.

IEFFA issues revenue bonds to finance small businesses in Illinois in the pollution control business or those which must add polution control equipment to meet regulations.

The Authority then loans the proceeds from the bonds to the business with long-term repayment scheduled at modest interest rates.

"We built a business where none existed, we provide jobs that weren't here before, we pay taxes, and now we're even conserving fuel, tires and equipment with the transfer station," Melhorn said.

"We're looking at a new trailer to buy this year, and we've got the site picked out for the second transfer station," Melhorn continued, "It's time to talk with the IEFFA again to try to work out the financing."

- more -

Baler Reduces Landfill Volume

In East Moline, Ill., solid waste handlers have gotten together to form the Metropolitan Reclamation and Transport Co. to sort, compact and bale trash for this Mississippi River town.

IEFFA provided them with $1,800,000 in revenue bond financing in early 1981 to permit the 25-ton per hour baling system to get underway.

After the nearby Rock Island landfill closed last year, local haulers looked for alternative ways to serve this highly industrial area.

The high-speed baler turns one ton of trash into one cubic yard for the landfill 19 miles away. The bales are loaded onto flat bed trucks for the trip because the tight compaction eliminates blowing and littering.

The revenue bond financing, covering 100 percent of the costs of business, costs the company 10.3 percent for 20 years.

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KB/km

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Disposal Service

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SIZE, SPEED KEYS TO EFFICIENT RESOURCE RECOVERY AT ILLINOIS WASTE DISPOSAL UNIT

Bigger is not necessarily better in resource recovery from solid wastes, according to Merle Buerkett, Springfield, Illinois. "Many operators, particularly municipalities, are building inefficiently large shredding and sorting plants," Buerkett said.

Buerkett, owner/operator of the M. Buerkett Landfill, serves the Sangammon County area in central Illinois with about 150,000 customers located within a 30-mile radius of his plant.

"We think we have installed the least costly, most efficient resource recovery system," Buerkett said, describing his one-year-old Saturn Model 50 shredder and Mayfran conveyor combination. The low-speed, shear-type rotary shredder processes up to 400 tons of mixed refuse per day and is installed on only 12 inches of mesh reinforced concrete.

- more -

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Waste Volume Reduced

Waste volume going into the landfill has already been reduced as much as four to one on some loads, but in the next year, Buerkett expects to install an air classifier from Iowa Manufacturing Co.

The resulting clean, combustible material will be sold as fuel and, eventually, may be compacted into cubes for even wider fuel uses.

The 600 h.p. shredder's low speed reduces noise, dust and flying debris compared to a hammermill-type unit. The explosions which occur with the hammermill type are almost eliminated. Materials like steel belted tires, engine blocks, and appliances that are a problem for the hammermill require no prior separation for the Saturn model. It uses less energy and is less costly to install.

Three employees per shift operate Buerkett's unit, and an additional shift is soon to be added due to the growing volume of business.

- more -

"Our operation is less vulnerable to shut-downs than the high-technology plants that rely on very large volume deliveries," Buerkett stressed.

Medium-size Facility Best Financially

The 250-ton per day plant that disposes of solid waste in the same area where it is generated and handles virtually every item hauled to it requires a relatively small investment, Buerkett maintains. "This is the optimum plant for the future," he said.

Buerkett financed his plant with the assistance of the Illinois Environmental Facilities Financing Authority (IEFFA) which makes financing available to small businesses in Illinois for pollution control equipment.

"IEFFA issues revenue bonds on behalf of several small businesses at a time," according to Ronald Bean, executive director. "The Authority lends the proceeds of the bond sales to the companies and repayment of the loan is guaranteed by the Small Business Administration. To encourage this type of action, the Internal Revenue Service (IRS) exempts investors from federal income tax on the return from such bonds."

- more -

Buerkett's loan of $1,000,000 was part of a bond issued April 1, 1980, for a total of $3,530,000 involving eight separate companies at 7% to 7-3/4% interest over 20 years. Conventional financing available at that time was considerably more costly, with interest rates at about 20%.

Daily Operation

The shredder is housed in a 120 x 200 foot metal building that Buerkett designed and engineered himself. The airplane hanger-type doors open to 70 feet and haulers drive onto the tipping floor to dump their loads at or near the conveyor so there is no blowing debris on access roads.

A front-end loader pushes wastes onto the conveyor as they arrive, eliminating stockpiling. Wastes travel the conveyor up into the hydraulically driven shredder where two rows of counter rotating cutter-discs produce uniform-sized product.

The nearly indestructible shredder stops automatically whenever the cutters reach a preset pressure limit. The cutters then reverse without any change of direction by the electric motor, pump or other components. The process can be repeated indefinitely without damaging the shredder.

- more -

The shredder can deliver 60 tons per hour to another conveyor that carries mixed waste through a magnet where burnable waste is separated from metal.

Until the air classifier is added, non-metal waste is conveyed through the wall of the building directly into the landfill. However, this process has already added as much as fifteen years to the life of the landfill, according to Buerkett.

Recovery Market Uncertain

Buerkett is well acquainted with the ups and downs of the market for recovered resources. A British firm talked to him a year ago about producing oil from shredded tires, but world-wide oil reserves have steadily increased and their interest decreased. There is currently no market for tin cans, Buerkett said, but he keeps his ears open. Ferrous metal scrap prices fluctuate so greatly that just breaking even looks good.

Buerkett is actively pursuing the use of wastes for fuel with both public and private outlets in the area. "I've offered a free trial," he said, "I'm that convinced the fuel will work to their benefit."

-- 30 --

KB/km

1. Merle Buerkett's shredder and sorter is housed in a metal building with airplane hanger-type doors. Up to 400 tons of mixed refuse can be processed per day.

2. Wastes move from the shredder (foreground) into the sorter (rear) and out of the building directly into the landfill (left).

3. Haulers dump their loads onto the floor as the base of the Mayfran conveyor. Buerkett pushes refuse onto the conveyor as it arrives, eliminating stockpiling.

4. Refuse leaves the 600-hp Saturn Model 50 shredder that was financed through Illinois Environmental Facilities Financing Authority bonds.

5. The Springfield, Il operator shreds tires and appliances because the equipment stops automatically when the cutters reach a preset pressure limit. The cutters can stop and reverse repeatedly without damaging the shredder.

pci

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GOVERNMENT ASSISTS PLATING FIRM
WITH POLLUTION EQUIPMENT LOAN

On the wall in the anteroom of the Del Mar Plating and Anodizing Co., Franklin Park, Illinois, hangs a framed, printed announcement of a $2.5 million bond issue involving the company. As a piece of art, this document will never be confused with a Renoir or Monet, but president Fred DeMaria says, "It's a good thing for people to see."

As a small businessman, DeMaria has a strong concern for the "bottom line." And, unless the bottom line is painted black, the business eventually will close, and people will lose their jobs. On the canvas of life, this is pale realism.

In 1980, DeMaria feared that he would have to close his business, which was started by his father in 1961. His electroplating operation was polluting the local water system at ph levels exceeding the standards determined by the Metropolitan Sanitary District of Greater Chicago. Plating and anodizing agents such as cyanide, cadmium, chromium, copper, zinc, nickel and others were the source of the problem.

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While no violations were ever cited, DeMaria realized that the Cyanide Destruct and Neutralization System he installed in 1970 was outdated. "We tried to upgrade our old system, but it just wouldn't work," he said. "A company such as mine must purchase up-to-date, effective pollution control equipment to stay in business."

DeMaria needed to purchase systems priced in the range of $100,000-plus. While the price alone made his heart flutter, the interest rates were ample incentive for cardiac arrest. With the prime interest rate hovering around 20 per cent, DeMaria would assume a 23 per cent annual finance charge with only a seven-year payback period for a piece of equipment that wouldn't generate any income. "At that rate, it's ridiculous," he sighed, enchoing a common refrain heard from small businessmen the last two years.

But DeMaria took advantage of an alternative which he believes saved his business. He had read some literature about government assistance in financing pollution control projects, and had heard a speaker address the same subject at an industry conference meeting. It was worth looking into.

He met with a representative from the First Wisconsin Bank of Milwaukee, who told him about the Illinois Environmental Facilities Financing Authority (IEFFA), an agency that provides financing at lower interest rates to small businesses for pollution control equipment.

The IEFFA provides loans by issuing revenue bonds at one time on behalf of a number of small businesses. The proceeds of the bond sales are loaned to the companies with a Small Business Administration guarantee for the loan repayment. To encourage purchase of the bonds, the Internal Revenue Service exempts investors from federal income tax on the return from the bonds.

"Most small businesses don't have easy access to capital markets markets, and banks are reluctant to loan them money for nonproductive assets such as pollution control equipment," explained Ronald Bean, executive director of IEFFA.

In DeMaria's case, even if banks were willing to provide a loan, high interest rates made this an unreasonable option. However, by meeting the requirements for the SBA guaranteed bonds, DeMaria secured a $180,000 loan at 12-1/2 per cent interest over a 20 year period -- definitely a more reasonable alternative. Included were the costs to prepare and issue the bonds.

According to DeMaria, the procedure for obtaining the loan was "really pretty simple." After completing a financial statement and general questionnaire, the wheels began to turn. "The First Wisconsin Bank of Milwaukee, working with the IEFFA, handled just about everything without a hitch. It took only 6-8 months to secure the loan. I was very pleased with the time frame."

DeMaria's new pollution control operation includes an ion exchange system that treats and eliminates the trade metals before they enter the sanitary system as an essentially clean fluid. "The sanitary district's job is easier becauue it doesn't have to treat the effluent. And we don't have to worry when a sanitary district truck drives up," cracks DeMaria.

Another feature of the system is a "make-up air unit." This unit exhausts the chemical and acid fumes plus the steam from the metal cleaning and rinsing tubs which are filled with scalding water. It also funnels a fresh supply of outside air into the plant. In addition to providing fresh air for easier breathing, the humidity level also is sharply decreased, and virgin metal is not as suseptible to rust, a primary concern before the system was purchased.

DeMaria claims none of this would have been possible without his IEFFA loan. "I really couldn't pay the commercial bank rates. They're devastating, and I don't think the business could have continued to make it."

According to Bean, Illinois companies received loans from bond issues in 1980, totalling about $12.8 million. These 14 businesses employ over 1,000 people whose jobs may have been in jeopardy without the IEFFA financing program.

✓ "We're providing pollution control equipment at reasonable costs in today's marketplace, which protects the physical environment and helps save jobs. It's a government program that really works. Small businesses' interest in the program grows continually," says Bean.

DeMaria supports the program wholeheartedly: "For me, it was terrific. Other people in the position I was in would be foolish not to consider it."

# # #

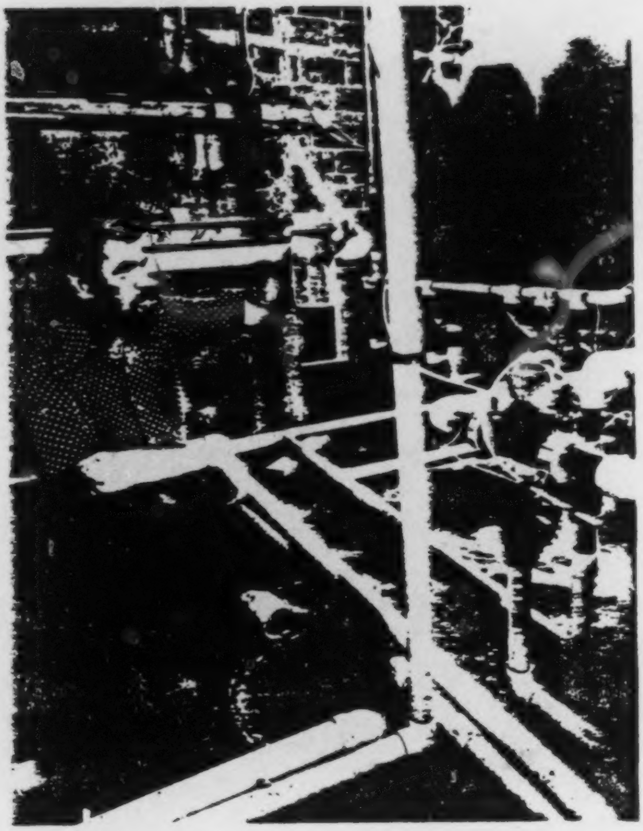

PHOTO CAPTION

Del Mar's general supervisor Jim Costello examines water which has been internally treated in recently installed pollution control equipment before it enters the public sanitary system.

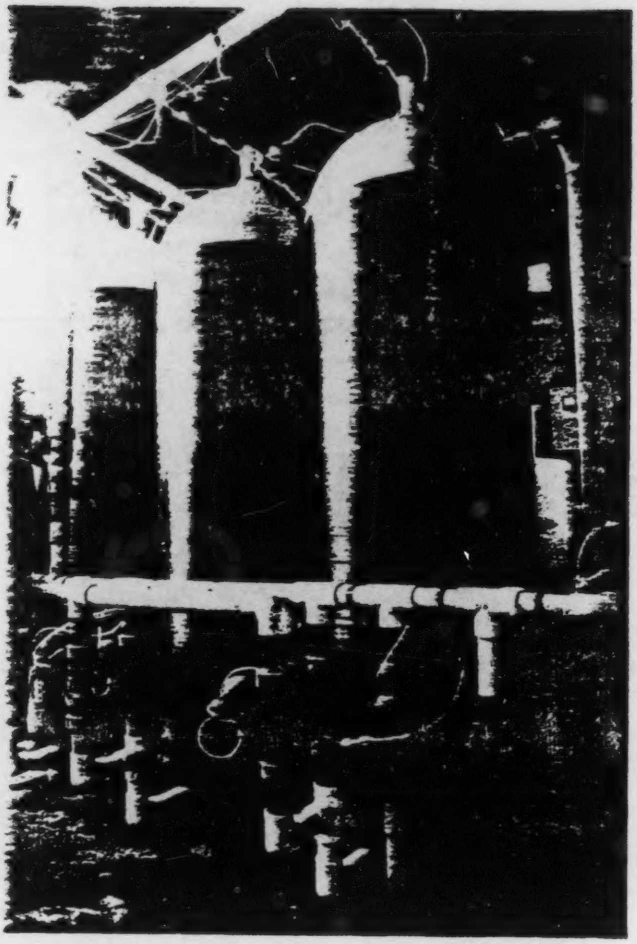

PHOTO CAPTION

Dirty water from the cleaning tanks and plating bins is pumped into these three filters which utilize a resin base to eliminate chemical impurities.

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WHEN YOU
WORK WITH
TURKEY

PHOTO CAPTION

Owner Fred DeMaria displays a jar of untreated water (left) and a jar of water which has been treated with his new system. DeMaria claims that a person could probably drink the treated water, although he wouldn't recommend it.

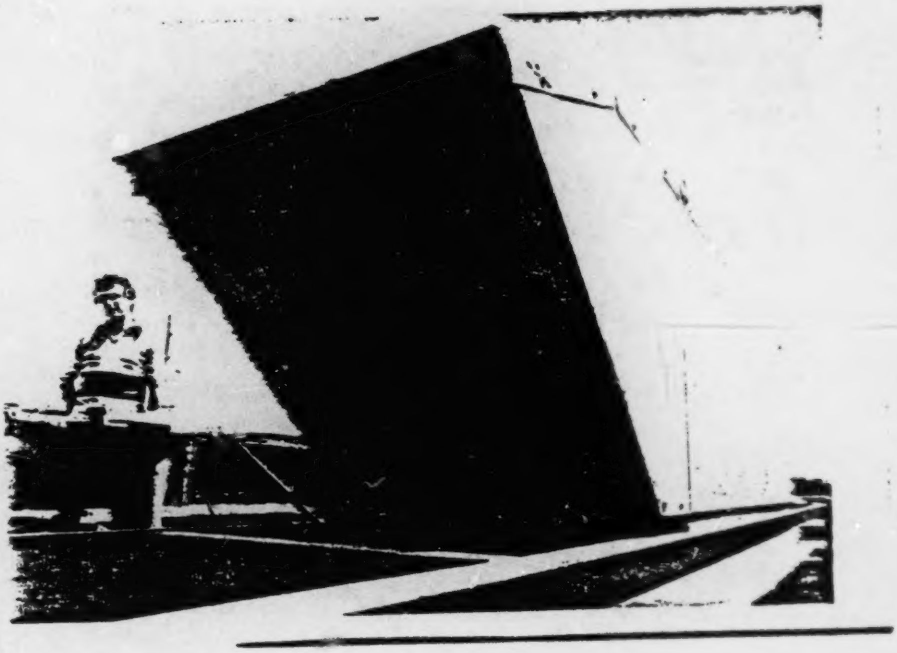

PHOTO CAPTION

Owner Fred DeMaria reviews the "make-up air unit" located on the roof of his plating and anodizing company in Franklin Park, Ill. The unit dramatically reduces the humidity level in the building by vacuuming steam and blowing fresh air into the work area. Installation of this unit has improved working conditions for the laborers and essentially eliminated rusting on untreated metals.

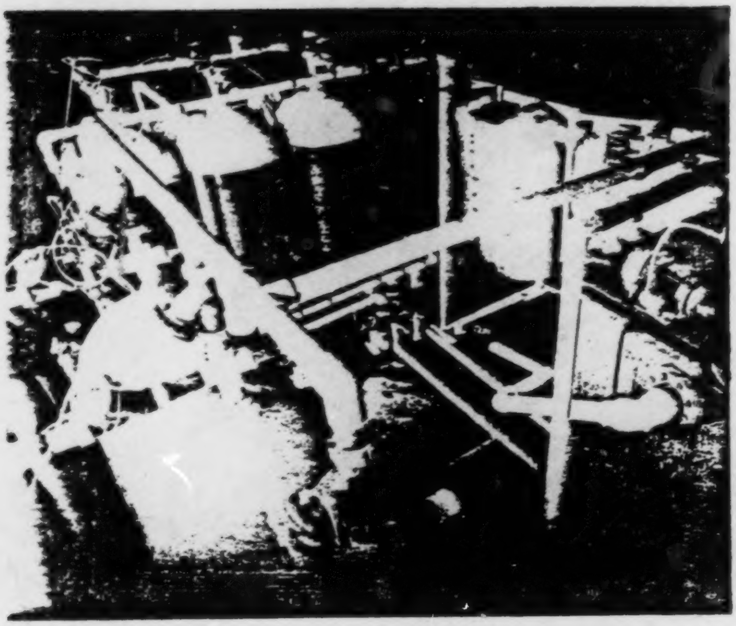

PHOTO CAPTION

Shown here is an overall view of the water pollution control unit recently installed at Del Mar Plating and Anodizing Company, Franklin Park, Ill. The unit includes a filtering system, (foreground), ion exchange tanks for filtered water, (background center), and sludge tanks (white, background right) for accumulated wastes which don't enter the public sanitary system.

EXHIBIT D

COUNCIL OF
POLLUTION CONTROL FINANCING AGENCIES

The Council is a national non-profit organization of state and local public agencies which issue pollution control revenue bonds and provide economic assistance to industry for financing pollution abatement facilities. It was formed in 1978, with the following objectives:

- To encourage and facilitate capital financing for environmental improvement and energy conservation.
- To support and further the interests of local and state agencies in assisting industry in achieving environmental quality goals.
- To aid and assist in the development of financial and economic incentives for environmental improvement.
- To support research and provide information about the needs, purposes and benefits of pollution control financing.
- To promote better coordination of federal, state and local policies and regulations for the compatibility of environmental improvement, efficient energy use and economic growth.

The Council provides technical assistance for its members' services for their communities. Among these are meetings and publications, sponsoring consultation among members, and program evaluation and recommendations. Council functions are designed to inform and educate the business, governmental and financial communities about the issues, developments and opportunities for more economical and equitable means of financing environmental improvement.

The Council's members are comprised solely of state and local units of government and their officials, and its Associates include banking, law, engineering and industrial firms.

COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES

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The CHAIRMAN. Mr. Hawk.

STATEMENT OF RICHARD C. HAWK, PRESIDENT, HIGHER EDUCATION ASSISTANCE FOUNDATION, OVERLAND PARK, KANS.

Mr. HAWK. Thank you, Mr. Chairman. My statement has been submitted for the record.

We believe that in considering the Treasury Department's proposals that the committee should be aware of several things with respect to student loan revenue bonds.

First of all, any effort to restrict utilization of student loan revenue bonds will be damaging to the national interest and public purpose of providing economic access to postsecondary education.

In the absence of student loan revenue bonds, tens of thousands of students will not have the opportunity to pay for postsecondary education costs from earnings after completion after the education. And all the revenue bonds issued for student loans represent a very small part of the total revenue bond market. They represent a full 20 percent of the funds available for the guaranteed student loan program.

No. 2, the impact of adoption of the Treasury recommendations would effect various parts of the country differentially. Those States which are in the fortunate position of being money centers have not found the use of revenue bonds necessary in order to meet student loan needs in those States—capital short States, like my own State of Kansas, have found it necessary to supplement the capital which was already available in the State from commercial lending institutions. Had the higher education loan program of Kansas not been able to provide financing from tax-exempt revenue bonds during last fiscal year, there would have been a short fall in the State of some $31 million, which would mean that some 15,000 Kansas students would not have been able to obtain loans unless they went to some other State for postsecondary education.

No. 3, student loan revenue bonds are pretty heavily regulated already. They are regulated not only by the Treasury regulations, as you know, but also by the Higher Education Act of 1965. There is a very specific provision in that act which requires an issuer of a tax-exempt revenue bond for purposes of guaranteed student loans to meet certain kinds of conditions, including the filing of a plan and the keeping current of the plan with the U.S. Secretary of Education.

In addition, Mr. Chairman, I would remind the committee that in the case of student loan revenue bonds, the Congress already has established a procedure for offsetting any loss in revenue to the Federal Government. As you know, the Federal Government pays an interest supplement in the form of a special allowance to holders of student loan revenue bonds in order to provide a competitive interest rate. In the case of student loans financed with revenue bonds, tax-exempt revenue bonds, the payment from the Federal Government to the holder of the loan is reduced by 50 percent.

In short, Mr. Chairman, we feel that the Treasury Department proposal with respect to guaranteed student loan revenue bonds is irrelevant because the public purpose of the guaranteed student loan program has already been determined by the Congress. We think that it is unnecessary because there is already adequate regulation of these bonds, both under Treasury regulations and also under the Higher Education Act of 1965.

Finally, we think it would be damaging to the national interest. And last but not least, discriminatory against those States which happen not to be in the fortunate position of being money market States.

Thank you.

[The prepared statement of Mr. Hawk follows:]

Statement
to
Committee on Finance
UNITED STATES SENATE
on
Tax Exempt Bonds for Guaranteed Student Loans

March 17, 1982

by

Richard C. Hawk, Chairman of the Board

HIGHER EDUCATION ASSISTANCE FOUNDATION
10950 Grandview
Overland Park, Kansas 66210

The Higher Education Assistance Foundation serves as the student loan guarantee agency in the states of Kansas, Minnesota, Nebraska, West Virginia, Wyoming and in Washington, D.C.

Statement to the Senate Committee on Finance
by
Richard C. Hawk

Mr. Chairman and Members of the Committee:

There are four major reasons why the Department of the Treasury proposal to limit revenue bond tax exemption under Section 103 of the Internal Revenue Code should not be applied to student loan revenue bonds.

I. The public purpose of guaranteed student loans already has been determined by the Congress.

Student loan revenue bonds are issued for the single purpose of obtaining capital for loans to students, or to parents on behalf of students, under the Higher Education Act of 1965, as amended. The Congress has wisely determined that providing economic access to postsecondary education for all eligible citizens, without regard to state of residence, is in the national interest. Indeed, the Congress has established certain federal subsidies to facilitate the availability of loans for eligible students in recognition of the public purpose served by providing a mechanism which permits payment of postsecondary education expenses from earnings after completion of the education.

The Treasury Department proposal for a public hearing and approval process to determine whether or not each bond issue to obtain funds for student loans serves a public purpose is at best an irrelevant procedure, creating an unnecessary expense for the states, and at worst a policy in direct conflict with the broader determination already established by the Congress.

II. The Congress already has established a procedure for reducing federal expenditures as an offset against any revenue loss from the tax exemption on student loan revenue bonds.

Although the federal government may lose some potential revenue by permitting interest on student loan revenue bonds to be exempt from federal income tax, the Congress has already established an appropriate arrangement for a compensating reduction in federal expenditures for subsidizing student loans. Quarterly special allowance payments by the federal government to holders of guaranteed student loans are reduced by 50% for all guaranteed student loans financed with tax exempt revenue bonds. For the quarter ended December 31, 1981, federal special allowance payments on nine-percent loans not financed with tax exempt bonds were made at the annual rate of 7%, while the comparable rate for student loans financed with tax exempt revenue bonds was 3.5%. Substituting taxable student loan financing with the corresponding increase in federal expenditures for special allowance payments would serve no useful purpose.

III. Limiting tax exempt revenue bonds as a source of capital for loans originated under the federal Guaranteed Student Loan Program would deprive tens of thousands of postsecondary education students of access to loans for postsecondary education.

Any action to limit the volume of student loan revenue bonds would be counter to the national interest of providing economic access to education for all eligible citizens, because the result of reduced student loan revenue bond volume would be a significant reduction in funds available for student loans. Lack of sufficient funds for student loans translates directly into denial of economic access to postsecondary education for many eligible citizens.

If the Congress determines that student loan volume should be reduced, such reduction should be achieved through changes in eligibility requirements, maximum loan amounts, or similar provisions which would continue equal opportunity, rather than by action to limit the amount of capital for which eligible citizens would have to compete.

IV. Limiting use of tax exempt revenue bonds as a supplementary source of capital for guaranteed student loans would discriminate against those states which happen not to be major money centers and would place a hardship on the residents of those states.

Those states in the fortunate position of being money centers may have sufficient capital available to meet the need for guaranteed student loans from funds held by commercial lending institutions. Such fortunate states have not had to use revenue bonds for meeting student loan needs. Other states--those with capital shortages--cannot meet the student loan needs of residents of those states entirely from funds of commercial lending institutions without a supplementary source of capital. These capital-short states have found use of revenue bonds necessary for providing economic access to education for all eligible residents.

The state of Kansas provides a convenient example. About 28% ($31 million) of student loans guaranteed in Kansas during fiscal year 1981 was made by the Higher Education Loan Program of Kansas, which was established in 1977 as a last resort lender to fill the gap between funds provided by commercial lenders and the amount needed to serve all eligible students. The gap exists in spite of a conscientious effort by commercial lending institutions to serve the needs of students while also serving substantial demand for agriculture, business, and other public and private loans. In fact, the annual volume of student loans made by commercial lenders in the state has grown from $10 million in fiscal 1977 to more than $80 million in 1981.

The proportion of the need which must be met through revenue bonds varies among the states. In fiscal 1981, it was only 24% ($8.9 million) in West Virginia, 47% ($104 million) in Minnesota and 77% ($38 million) in the District of Columbia. For those students whose needs would not have been met without capital generated from tax exempt revenue bonds the situation is critical, whether the state needs 24% or 77%.

The effect of the Treasury Department recommendation to require a state contribution to each student loan revenue bond issue would be to penalize those states which are already having difficulty in generating sufficient funds to meet student loan needs. Those states which are fortunate enough to be able to depend solely on relatively larger amounts of capital held by commercial lending institutions within those states would not be similarly penalized. The states of Colorado, Idaho, Iowa, Nebraska, Texas, Virginia, and Wyoming--to mention just a few more--will be affected negatively by the Treasury proposal.

If the Congress determines that availability of student loans should be contingent upon a capital contribution by the state in which the citizen happens to reside, the contribution should be required through a more direct means which would not discriminate against those states which are already experiencing difficulties in generating sufficient capital to meet guaranteed student loan needs.

The Treasury proposal to eliminate arbitrage from investment earnings on bond proceeds and reserve funds would have the same effect as requiring a contribution from each state. Under current economic conditions, elimination of those investment earnings would put capital-short states in the position of either not issuing revenue bonds and not meeting the needs of all students in the state, or making a financial contribution in support of bond issues. The coupon interest rate on student loan revenue bond issues typically is in excess of 9% and sometimes exceeds 11% under current conditions. Because the assured return to the lender on a guaranteed student loan is only 9.5%, the lack of opportunity for earnings on investments would destroy the financial feasibility of most student loan revenue bond issues.

Summary

In summary, applying the Treasury Department proposal to student loan revenue bonds is (1) irrelevant for determining the public purpose of these bond issues, because the public purpose of these single purpose bonds has already been established, (2) unnecessary to avoid a federal revenue loss, because the Congress has already acted to offset revenues lost from tax exemption on these bonds with a specific reduction in federal expenditures for loans financed with revenue bonds, (3) damaging to the national interest, because the proposal would reduce economic access to education and restrict opportunity for payment of expenses after completion of the education, and (4) discriminatory against capital-short states which must either depend on revenue bonds to fill the gap between capital which can be provided by commercial lending institutions and the amount of student loan needs or permit a significant portion of the need to go unmet.

The **Chairman**. Let me just quickly ask a couple of questions. And then I will have to recess the hearing until I come back. It will be about 15 minutes.

The provision for tax-exempt bonds for pollution control was enacted before the major pollution laws in the early 1970's were passed. Presumably, pollution control bonds were intended to encourage voluntary efforts to clean up the environment. Now that we have mandatory rules, do we still need the IDB's? If you have mandatory rules, why do you need them? And, second, if we subsidize credit for industries that pollute, don't we actually encourage pollution-prone industry? That is, we free up other sources of credit and more equity financing for the nonpollution control equipment used in those industries.

Mr. **Bean**. I don't necessarily agree. I think that the availability of this kind of financing for many companies is the difference between complying with the mandatory requirements of Federal, State and local governments or going out of business. I think that I could, for the record, give you many examples of companies that we have financed in Illinois that could not meet the requirements but for the availability of tax-exempt financing.

The **Chairman**. Well, let me just follow that up. Since Dow Chemical and other big chemical companies and paper companies and steel companies use pollution control bonds, why don't we limit pollution control bonds to small business? Just like small issue bonds. You don't think we ought to subsidize credit for Dow Chemical or United States Steel or other large corporations, do you?

Mr. **Bean**. Well, I think that the distinction that I would make is that the introduction of this equipment into the process, particularly the end-of-pipe technology that is encouraged by the laws presently, does not increase productivity. In fact, it's a drain on the capital of those companies. And that to possibly meet the question that you are raising, the issue you are raising, is that the law could be targeted to encourage pollution abatement, as well as pollution control, so that the pollutant is never created in the first instance, thereby creating a hazard that must be in some way disposed of.

The **Chairman**. Again, let's get back to the basic subject of why we need to subsidize somebody for doing what they should or must do in the first place. Why should taxpayers in another State pay for pollution control subsidies in your State or Ohio or in my State. Shouldn't your customers or your sharedholders pay instead? I don't suggest we can solve that this morning, but these are some of the basic questions that are raised.

We are in a desperate search to reduce the deficit and to get interest rates down, which also impacts on Ohio and Illinois and Kansas. And if everybody walked in and said they didn't want to do anything, and we said, "OK, we won't include your group or your group," I'm afraid we wouldn't have much success this year in having any successful effort to cut spending without raising more taxes on the very people that we are concerned about.

Your statements will be made a part of the record. And I apologize to the last two witnesses. I will run down the hall so Senator Thurmond won't run up here after me. And then I will be back in about, hopefully, 10 minutes. If worse comes to worse, we will figure out something else.

[Whereupon, at 11:23 a.m., the hearing was recessed.]

AFTER RECESS

The **Chairman**. I have visited the Judiciary Committee and I'm not needed for about 7 or 8 minutes. Maybe we can avoid further inconvenience to the witnesses and ask Mr. Potts and Mr. Clyde to come forward and hopefully they can summarize their statements. We are hoping another Senator may come along to this committee. But if not, at least you will have the statements in the record and I will be able to submit some questions.

Is Mr. Clyde here?

Mr. **Clyde**. Yes, sir.

The **Chairman**. Mr. Potts, according to my schedule, you are first.

STATEMENT OF RAMSAY D. POTTS, ESQ., COUNSEL, NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, WASHINGTON, D.C.

Mr. **Potts**. Mr. Chairman, my name is Ramsay Potts. I am counsel to the National Committee on Small Issue Industrial Development Bonds.

The committee presently has 92 members, principally manufacturing corporations, but also State economic development organizations, some investment banking groups, and other supporting entities.

Mr. Chairman, I intend to concentrate my remarks on an issue that has been highlighted today by your questions and by your comments. And I hope I can at least persuade you to reexamine the issue because I know you have an open mind.

Large- and medium-sized businesses face the same problem of the cost of capital that all businesses face, and they are postponing investment and reducing employment as they are squeezed by interest rates. The daily papers are filled with reports of plant closings and workers losing their jobs. One thing I hope you won't forget and that is that when GM closes a plant, it has a ripple effect and that effect goes right down to the small business plants in communities all over the country.

When considering the construction or expansion of a facility, large companies, just like small ones, have to evaluate the cost and the potential return before an investment is made. In order to be approved, the project must pass what the companies call the hurdle rate for return on investment. If it doesn't pass the hurdle rate, the company might as well make the investment in money market funds or something else.

At today's interest rates, projects of even the larger companies often do not exceed the hurdle rate if they must be financed at market rate. Eliminating the use of IDB's by large- and medium-sized companies is going to reduce capital investment so projects will be delayed or abandoned.

The United States remains, for the time being, the world leader in high technology and in manufacturing exports. Our position, however, as we all know is being eroded in these fields just as it already has been in automobiles, in steel, in cameras, and in televisions and radios. We have been losing out for years to Japan in modernizing plant and equipment. I remember when Senator Bentsen came back from the Far East about 2 years ago—he had held hearings out there—he told me at that time that he was absolutely startled and dismayed to find that Japan was turning over their plant and equipment every 10 years, and we were turning ours over every 30 years. This is the root cause of our problem in competitive markets.

What we should be talking about is increasing the present limits on IDB's rather than constricting them. If the 1968 limits had kept pace with inflation, the $10 million limit that is now in place would be $15 million in mid-1982. In other words, we need $15 million as the limit just to stay even.

The Treasury's proposal that corporations be limited to $10 million in outstanding small issue IDB's at any one time would eliminate corporations of all sizes. Not just large companies, not just Fortune 1,000 companies; it would eliminate all but the very smallest companies if a company had financed one or two facilities with small issue IDB's. It would also remove from the State and the local governments the authority to choose what investment and economic development mix they want.

Now I have some figures here about the effectiveness of IDB financing in creating jobs and economic activity in the States of the Senators who are on this committee. I was hoping that some of them would be here so I could summarize for them the information about their States. But the information will be in the record, and they can look at it.

The CHAIRMAN. I might say that I think every member has a staff person present.

Mr. POTTS. They will be able to see that data which is in the written statement.

Elimination of large- and medium-sized businesses from using IDB's is not going to eliminate the so-called abuses in the program. It will leave many of those activities intact, cited as abuses in published reports. In the congressional hearings over in the House last year, there was absolutely no criticism whatsoever of any large company using IDB's. The criticism was all directed at commercial use.

Competitive interest rates for borrowing to finance new plants and equipment are essential if U.S. firms are going to compete in domestic and international markets. Now here are some figures about what the Japanese do. They use preferential interest rate financing. They use interest-free loans to encourage certain export-related priority industries. Loans made for technology projects by the Ministry of International Trade and Industry in Japan bear no interest. Loans made by the Japanese Development Bank bear a preferential interest rate of 7.5 percent. How can we compete in this country if our corporations have to finance new plant and equipment at 15 to 18 percent. This is a more important factor in the competitive position of U.S. industry than the so-called advantage of low wages. This is more important than the wage differential.

Because of exorbitant interest rates, American firms have trouble producing a competitively priced product. As a result, American firms are increasingly losing out in both the international and the domestic market right here in the United States to Japanese firms and other foreign firms who obtain capital at a lower cost.

This is in conclusion, Mr. Chairman. Any proposal to prevent large- and medium-sized businesses from using small issue IDB financing either by a worldwide capital expenditure cap or a cap on the dollar volume of all outstanding small issue IDB's or a proposal to require a choice between IDB financing or ACRS is going to have a damaging economic effect on the communities that seek to attract businesses. And it is going to have a damaging effect on the jobs created and retained by IDB financing and on the competitive position of the United States against Japan and other foreign countries.

Moreover, the damaging economic impact is going to far outweigh any estimated revenue gain from the elimination of use of IDB's by large- and medium-sized businesses. If we use Senator Long's dynamic analysis rather than a static analysis it can be proven that IDB projects produce revenue gains. Dr. Ture, in a study he did for our committee, showed that you have a favorable impact on Federal revenue by IDB financing.

The CHAIRMAN. Well, your entire statement will be made a part of the record.

[The prepared statement of Mr. Potts follows:]

Statement of
Ramsay D. Potts
Counsel to the National Committee on
Small Issue Industrial Development Bonds

before the

Committee on Finance
United States Senate
March 17, 1982

Summary

The National Committee opposes the Treasury's proposals which would require assets financed with industrial development bonds (IDB's) issued after 1982 to be depreciated using the straight-line method over an extended recovery period and would eliminate the use of small issue IDB's by large businesses.

The National Committee is convinced there are compelling reasons why these proposals should be rejected. These reasons include inordinately high interest rates, high unemployment, the needs of the communities to have economic development tools, and the need to address the abuses in the IDB program.

The National Committee is certain that continued use of IDB's for industrial purposes is of utmost importance in the present economy to modernize and make more productive the nation's manufacturing and processing industries and to meet foreign, especially Japanese, competition. It also believes that concern over small issue IDB's has been exaggerated out of all proportion to any estimate of possible revenue gain.

If, however, the Congress concludes that the use of IDB's should be restricted because of the criticism of the so-called abuses and the proliferation of IDB uses, the National Committee urges that the use of IDB's for industrial purposes be retained.

Statement of
Ramsay D. Potts
Counsel to the National Committee on
Small Issue Industrial Development Bonds

before the

Committee on Finance
United States Senate
March 17, 1982

Mr. Chairman and members of the Committee, my name is Ramsay D. Potts. I am counsel to the National Committee on Small Issue Industrial Development Bonds. I am also a senior partner in the Washington law firm of Shaw, Pittman, Potts & Trowbridge. I appreciate this opportunity to present the views of the National Committee on small issue industrial development bonds ("small issue IDB's"). The National Committee on Small Issue Industrial Development Bonds is a non-profit membership organization dedicated to preserving and increasing the effectiveness of small issue industrial development bonds as mechanisms for capital formation and job creation. The Committee presently has 92 members, principally manufacturing corporations, but also state economic development organizations, investment bankers and other supporting individuals and groups. 1/

1/ List of members of the National Committee on Small Issue Industrial Development Bonds (Attachment A).

Our Committee has been actively involved in matters affecting small issue IDB's since 1978. Our members have worked closely with state and local economic development authorities to understand their needs and concerns. Several state authorities are supporting members of our Committee. The National Committee has commissioned two studies on small issue IDB's. The first, "The Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions" by Dr. Norman B. Ture, now Undersecretary of the Treasury for Tax and Economic Affairs, was published in 1980. The second on "The Federal Revenue Losses from Industrial Development Bonds" by Roger C. Kormendi and Thomas T. Nagle of the University of Chicago, was published in 1981.

The National Committee recognizes that there are different views regarding the impact on the Federal revenue of small issue IDB's, depending on the formula or approach used. The dynamic or feed-back approach, advocated by Dr. Ture in the study he did for the National Committee, concludes that the Federal Treasury gains net revenues from the IDB program. In any event, the dollar figures of revenue loss from small issue IDB's advanced by critics of the program are entirely speculative and small in comparison with the revenue losses from other recently-enacted tax provisions, including the tax leasing provisions and the 10 percent cut in personal income tax rates scheduled for July 1, 1983.

The National Committee's Position

The National Committee recognizes that there has been publicity about and criticism of aspects of the small issue IDB program. The Committee believes, however, that the criticism has been out of all proportion to the incidents of abuse. If the Congress, nevertheless, concludes that abuses in the program and the proliferation of IDB issues warrant changes and restrictions at the Federal level on the issuance of IDB's, we urge the Congress to retain the use of IDB's for industrial purposes.

The original purpose of the IDB program was to use IDB's to finance industrial facilities. It continues to be the primary purpose in many states. Furthermore, at the extensive hearings on small issue industrial revenue bonds before the House Ways and Means Oversight Subcommittee in April 1981, no abuses were cited in the use of IDB's for industrial purposes, and there was virtually no criticism of the continued use of IDB's for industrial purposes in the Oversight Subcommittee's report and recommendations.

IDB's are now being used to finance industrial facilities in 48 states from Alaska to Florida from Michigan to Mississippi. IDB's have provided access to capital, which made possible the much-needed investment in plant and equipment and created new jobs or retained existing jobs. These industrial jobs are the core jobs, the long-term, permanent jobs that a community needs. The location or retention of an industrial facility in the community creates a ripple effect in the community, attracting other smaller firms, creating service jobs, increasing the local tax revenues and encouraging further economic development.

The National Committee's position is to support the continued use of IDB's for industrial purposes and to recommend that the use of IDB's for commercial purposes be targeted to economically distressed areas. The National Committee has no objection to the use of IDB's for commercial purposes per se but has adopted this position in support of targeting of commercial uses in response to the criticisms of the so-called abuses, the concern about the growing volume of IDB's and the proliferation of non-traditional uses.

The definition of economically distressed areas should be determined by the Congress. There are some definitions presently available, such as the Urban Development Action Grant Program ("UDAG"), which has developed recognized criteria for economic distress for cities and urban counties and for pockets of poverty in non-distressed cities. Other standards based on unemployment and income could be developed, which would give the states some flexibility in designating areas for economic revitalization. Several states, including Massachusetts and New Jersey, have developed such programs for targeting commercial uses.

In addition, the National Committee supports the following positions regarding small issue IDB's:

Legislation should include a provision to eliminate research and experimental expenditures from the definition of capital expenditures for purposes of the small issue exemption. Bills in support of this position were introduced by Senator Moynihan (S. 768) and by Senator Denton (S. 1472) and language to this effect was adopted by the Senate as an amendment to a miscellaneous revenue bill H.R. 4717 in December 1981, but is still pending conference.

The National Committee also supports legislation to require reports from the states to the United States Treasury regarding all state and local IDB's issued during the year and to require public notice and the opportunity for public comment or protest prior to the approval of the issuance of an IDB. The National Committee regards the specific language that implements these requirements as critically important because it is crucial that the requirements do not overburden and complicate the issuance of IDB's to a point where the programs are paralyzed or eliminated. We have analyzed these two recommended changes in the program with considerable care and have drafted language that meets the concerns of and is acceptable to the IDB community, which we will make available to the staff, if the Committee decides to amend the existing legislation.

Opposition to the Treasury's Proposals

The National Committee strongly opposes the Treasury's proposals that would require assets financed with industrial development bonds issued after 1982 to be depreciated using the straight-line method over an extended recovery period and would eliminate the use of small issue IDBs by large businesses. The National Committee believes there are compelling reasons why such proposals should be rejected. These reasons include inordinately high interest rates, high unemployment, the needs of the communities to have economic development tools, and the need to address the abuses in the IDB program.

A legislative proposal to prevent double dipping, that is, to require a choice between the use of IDB financing and accelerated cost recovery system ("ACRS") is counterproductive to the Administration's goal of economic recovery because:

(1) The needs and benefits are different: IDB financing reduces the initial cost of the financing. It assists in making capital available to industries. It spurs the modernization of plant and equipment now rather than at some future date. It addresses businessmen's concerns regarding the persistent and inordinately high interest rates which have caused this present recession, prevented investment, created unemployment and reduced output. As the Wall Street Journal stated, quoting Lee Iacocca on Friday, February 19, "There

is no way for business to do business when the rates are between 15 percent and 20 percent." In spite of the Economic Recovery Tax Act of 1981, business is revising its investment plans downward rather than upward because the steep rise in interest rates has offset the incentives of ACRS. Economist Rudy Penner of the American Enterprise Institute was reported in The Washington Post on Friday, February 19, as saying that "the additional cost of capital because of higher interest rates now outweighs the tax-induced reduction in the cost of buying new plants and equipment."

(2) In addition, the uneven treatment under ACRS of different assets and industries has been documented by the Economic Report of the President (February 1982, pp. 124-125) in that investments in longer-lasting machinery and buildings are treated less favorably. Industries dependent on these investments such as industries producing machinery and instruments, food, services and trade, will continue to have higher effective tax rates and will be treated least favorably.

(3) ACRS affects the cash flow and the rate of cost recovery. It is especially important to business in an inflationary period, but it does not reduce the initial cost of obtaining capital. Furthermore, interest costs, once incurred, unlike some operating costs, do not decrease

during periods of economic slowdown. The high initial cost of obtaining capital is, therefore, the significant impediment to investment in the present economic climate.

(4) Interest rates and the rate of inflation are separate issues. The Administration has made great strides in reducing inflation, but it has been unable to reduce interest rates, and the consequences of persistently high interest rates are apparent in the unemployment figures, in declining output, and in delayed investment. Until interest rates are substantially reduced, IDB financing is one of the few ways business can undertake new investments in plant and equipment.

The Administration's proposal to prevent large businesses from using small issue IDB's is also counterproductive to the Administration's economic goals because:

(1) The states and local governments want to retain the right to decide when and where they may want large and medium-sized businesses to locate in their communities since it is these firms that provide permanent employment, generate increased tax revenues, serve as a magnet for attracting other firms and generally are responsible members of the community. Moreover, the arrival or retention of a large or medium-sized firm is a catalyst for economic recovery because

it creates a ripple effect of additional jobs, services and investment in the community. The state and local governments are facing substantial cuts in federal assistance, decreased tax revenues, increased transfer payments and substantial new responsibilities under the Administration's proposed Federalism. They need IDB's more than ever to provide economic development and to replace the programs and services that are being terminated by the Administration's budget cuts.

(2) No state at present excludes large or medium-sized businesses from its IDB program; on the other hand, many states limit the use of IDB's to industrial, manufacturing and processing uses and exclude or restrict the use of IDB's for commercial purposes.

(3) Large and medium-sized businesses face the same problem of the cost of capital that all businesses face, and they are postponing investment and reducing employment as they are squeezed by interest rates. When considering the construction or expansion of a facility, large companies, just like small ones, must evaluate the costs and potential returns before an investment can be made. In order to be approved, the project must pass the "hurdle rate" for return on investment. At today's interest rates projects of even the largest companies often do not exceed the hurdle rate if

they must be financed by market rates. Eliminating the use of IDB's by large and medium-sized companies will reduce capital investments as projects are delayed or abandoned.

(4) Elimination of large and medium-sized businesses from the IDB program would discriminate against manufacturing and industrial firms. These are the firms that have major capital expenditures and that have been most affected by the present interest rate-caused recession.

(5) Furthermore, the $20 million cap on worldwide capital expenditures that Treasury is proposing would affect high technology firms of all sizes. These firms operate in a highly competitive, rapidly evolving industry in which equipment and products must be updated constantly. Although many of these firms are small, they frequently have worldwide capital expenditures in excess of $20 million in a six-year period, and they have the potential to grow rapidly. The Administration's proposal would discriminate against the most productive uses of IDB's for high technology and manufacturing exports in which the United States remains, for the time being, the world leader. The United States position, however, is being eroded in these fields as it has been in such industries as automobiles, steel, cameras, televisions and radios. The present $10 million limit on the bonds issued and on the capital expenditures within a six-year period already imposes severe restrictions

on the size of facilities financed with IDB's. If the 1968 limits had kept pace with inflation, the $5 million limit enacted in 1968 and the $10 million enacted in 1978 would be $15 million in mid-1982.

(6) The Treasury's proposal that corporations be limited to $10 million in outstanding small issue IDB's at any time would also eliminate corporations of all sizes, if a firm had financed one or two facilities with small issue IDB's. It would also remove from the states and local governments the authority to choose what investment and economic development mix they want.

(7) Unemployment is severe in certain industries and areas which have used IDB's successfully for the creation and retention of jobs. In the current recession, blue collar workers in the goods-producing sector have borne the brunt of the unemployment rate, which increased to 12.9 percent for them in January. The effectiveness of IDB financing in creating jobs has been demonstrated by the following information provided to us by the States. For example, Delaware has created 7,276 jobs through the use of IDB financing since 1976. Louisiana estimates that it has created or anticipates the creation of 9,667 permanent jobs and 15,999 temporary jobs in connection with IDB projects financed with IDB's from 1979 to 1981. Oregon granted IDRB project eligibility to 36 companies during calendar year

1981. These firms estimate that they will create 1,638 full-time jobs within 3 years of completion of the IDB financed facilities. Rhode Island estimates that IDB facilities created 1,781 jobs in 1981. New Jersey reports that 65,000 persons are currently employed in permanent jobs that have been created by IDB financed facilities since 1974. For 1981, New Jersey estimates that 13,336 new permanent jobs and 11,182 construction jobs will be created from the IDB financed facilities. St. Louis County Industrial Development Authority has issued 98 bonds since its inception in 1979 for facilities which have created or will create 4,800 jobs in St. Louis County. Adams County, Colorado, reports that 28 IDB's issued in 1981 are estimated to create between 1,300 and 1,600 jobs over the next ten years. Mississippi, the first state to use the program, has continued to use it almost entirely for industrial purposes. Like the other states, Mississippi has no prohibitions regarding the size of the company which may use IDB financing. Over a forty-year span, Mississippi has used IDB financing to build plants for at least 55 corporations among the Fortune 500 industrial corporations and credits its IDB program as vital in its development of industrial facilities and industrial jobs in the State.

(8) Elimination of large and medium-sized businesses from using IDB's would not eliminate the so-called abuses

from the program. It would probably leave the majority of those activities, cited as abuses in published reports and Congressional hearings, intact while hurting community economic development efforts and the creation of core jobs.

Favorable interest rates for borrowing to finance new plant and equipment are essential if United States firms are to compete in the domestic and international markets.

(1) The Japanese use preferential interest-rate financing. In fact, they use interest-free loans to encourage certain export-related priority industries, in conjunction with a rapid depreciation schedule to encourage investment. Loans made for technology projects by the Ministry of International Trade and Industry (MITI) bear no interest. Loans made by the Japanese Development Bank (JDB) bear a preferential interest rate of 7.5 percent compared to the Japanese long-term prime rate of 8.9 percent in November 1981. Savings are encouraged by making the annual interest on the first $3 million yen deposited in the Postal Savings System tax-free for each depositor. In addition, the annual interest rate on these savings is 6.25 percent, which is the same rate as interest earned on time deposits at commercial banks.

(2) Because of these favorable interest rates, American firms which have to borrow money at 15 percent to 20 percent,

cannot produce a competitively priced product. As a result, American firms are increasingly losing out in both the international and the domestic markets to Japanese firms and to other foreign firms which can obtain capital at a lower cost.

CONCLUSION

Any proposal to prevent large and medium-sized businesses from using small issue IDB financing, either by a worldwide capital expenditure cap, or a cap on the dollar volume of all outstanding small issue IDB's for the use of any one company, or a proposal to require a choice between IDB financing or ACRS will have a damaging economic impact on the communities that seek to attract industry, on the jobs created or retained by IDB financing, and on the competitive position of United States firms against Japanese and other foreign firms. Moreover, the damaging economic impact will far outweigh any estimated revenue gains from the elimination of the use of IDB's by large and medium-sized businesses.

The economy is going through a period of great stress and strain, largely attributable to inordinately high interest rates. Competition from foreign manufacturers is eroding the position of United States industry in both international and domestic markets in an ever-increasing number of product lines. In addition, the Administration is cutting back on many programs and services provided to states, cities and local communities. The National

Committee is convinced that this is the wrong time to be curtailing the small-issue IDB program especially for industrial uses, because the IDB program has proved to be a valuable and important financing tool for states, cities and local communities. Moreover, the National Committee is convinced that concern over small issue IDB's has been blown out of all proportion to the incidents of abuse and the estimated revenue loss from small issue IDB's. If, however, there is to be modification of the program because of the criticism of the abuses, then the National Committee urges that the Congress retain the use of IDBs for industrial purposes and not impose any restrictions on the size of the company eligible to use this financing.

ATTACHMENT A

National Committee on Small Issue Industrial Development Bonds

March 1, 1982

MEMBERS

ABS Industries, Inc.
Ajax Magnethermic Corporation
Akron Foundry
American Greetings Corporation
Anheuser-Busch, Inc.
Baldor Electric Company
Ball Corporation
George K. Baum & Co.
A. G. Becker Inc.
The Binswanger Co.
William Blair & Company
Boettcher & Company
Buffalo China, Inc.
Campbell Taggart, Inc.
Cargill Inc.
Carlisle Corp.
Chromalloy American Corp.
The Continental Group, Inc.
Copeland Corp.
Copperweld Corp.
Corning Glass Works
Dain Bosworth Corp.
The Dyson-Kissner-Moran Corporation
E. F. Hutton & Company Inc.
Eagle-Picher Industries, Inc.
A. G. Edwards & Sons, Inc.
Emerson Electric Co.
Essex Company
First Birmingham Securities Corp.
The First Boston Corporation
First Southwest Company
Franklin Electric Co.
Gantz Investment Company
Goldman, Sachs & Co.
Guild Craftsmen, Inc.
Hart Corporation
Hayes, Inc.
Health Care Fund
Hoover Universal, Inc.
The Hospital Corporation of America
J.C. Bradford & Co.
Joy Manufacturing Company
The Kroger Company
Langenthal Mills

The Marmon Group, Inc.
McDonald and Company
Mine Safety Appliances Co.
The Mortgage Corporation of America
Omark Industries
Plymouth Tube Co.
Portec, Inc.
Powell & Satterfield, Inc.
PPG Industries, Inc.
Ralston Purina Company
Renfrow Foundry
Robinson Foundry, Inc.
The Robinson-Humphrey Co.
South Haven Rubber Co.
Southwire Company
Stephens Inc.
Stifel, Nicolaus & Company Incorporated
Stihl Incorporated
The Synthetics Group
T. J. Raney & Sons, Inc.
UNIPAR Inc.
Vermont American Corp.
Wagner Division - McGraw-Edison Co.
Wetterau Inc.
Wheat, First Securities, Inc.
White Consolidated Industries, Inc.

SUPPORTING ORGANIZATIONS AND INDIVIDUALS

Alaska Industrial Development Authority
Allegheny County Industrial Development Authority
Ballard, Spahr, Andrews & Ingersoll
Chapman & Cutler
Friday, Herschel H.
Gambrell, Russell and Forbes
Georgia Industrial Developers Association, Inc.
Hawkins, Delafield & Wood
Commonwealth of Kentucky, Development Finance Authority
State of Illinois, Department of Commerce & Community Affairs
State of Indiana, Department of Commerce
State of Maryland, Department of Economic and Community Development
North Carolina Industrial Developers Association
North, Haskell, Slaughter, Young & Lewis
Ohio Economic Development Council
Pennsylvania Association of Industrial Development Authorities
Southern Industrial Development Council
St. Louis County Industrial Development Authority
Tennessee Industrial Development Council
Commonwealth of Virginia, Division of Industrial Development
Watkins, Ludlam & Stennis
Wright, Lindsey & Jennings

The CHAIRMAN. Mr. Clyde.

STATEMENT OF LARRY F. CLYDE, CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, NEW YORK, N.Y.

Mr. CLYDE. Mr. Chairman, thank you. Mr. Chairman, my name is Larry Clyde. I am chairman of the board of the Public Securities Association. PSA is the national trade association representing banks, dealers, and brokers that underwrite, trade, and sell State and local government securities and Federal securities. My remarks will address the effects on the municipal securities market of two tax proposals contained in the administration's 1983 budget—the corporate minimum tax and the restrictions on industrial revenue bonds.

PSA members serve as intermediaries between State and local governments and investors to arrange capital financing for such critically important projects as schools, ports, hospitals, and airports. We expect to continue to underwrite and distribute municipal securities whether or not the Congress enacts the administration's tax proposals. We are concerned, however, with the impact of these proposals on the ability of State and local governments to meet their capital financing requirements.

We will address only one aspect of the administration's minimum tax proposal. This is the limitation on tax deductions taken by banks and other financial institutions for interest paid on deposits to the extent they hold municipal securities.

PSA is deeply concerned by the implications of this proposal, since it will signficantly reduce the future participation of commercial banks as investors in tax-exempt bonds. We estimate that this proposal will cost state and local governments at least $1 billion in higher interest rates in the first year alone.

Maintaining commercial bank demand for municipal securities is critical to the future of the municipal securities market. At the end of 1981, commercial banks held about 42 percent or $150 billion of outstanding municipal bonds. Any proposal which severely reduces the net after-tax yield of these investments for banks could drive this market's largest single investor to other available forms of investment.

This proposal would amount to a retroactive and indirect tax on the obligations of State and local governments. In our opinion this would breach the constitutional wall of reciprocal immunity which has prevented State taxation of Federal debt obligations and, conversely, Federal taxation of State and local obligations.

The retroactive application of this proposal will create uncertainty among all investors in these securities. It will force them to require a margin of safety against the prospect of further retroactive tax intrusions. Therefore, all investors will demand higher rates on all new purchases of municipal bonds.

The tax exemption for municipal bonds is, a quid pro quo for the acceptance by the investor of lower rates of return than he could have obtained on taxable investments. Thus, in a very real sense, the investor in tax-exempt bonds has already paid a tax in the form of a lower rate of return.

For State and local governments, this proposal represents another in a series of recent Federal actions which are continuing to promote upward pressure on municipal borrowing costs. Severe reductions in Federal assistance to State and local governments and several provisions of the 1981 Tax Act have already exacerbated the burden of high interest rates on the municipal securities market. At the same time, State and local governments will be expected to accept new responsibilities under the new federalism initiative.

We also understand that this committee is considering broadening the current minimum tax proposals to include interest earned on municipal securities by corporations and individuals. This direct form of taxation of State and municipal securities would not only, in our opinion, be unconstitutional, but would devastate the municipal market.

When a minimum tax including interest earned on municipal bonds passed the House of Representatives in 1969, investor confidence in the tax-exempt feature of municipal bonds was severely shaken. And tax-exempt interest rates quickly approached rates on taxable bonds. We certainly don't want to witness a repeat of the 1969 experience, particularly now when the municipal market is already suffering from historically high interest rates.

The administration has also proposed new restrictions on the controversial small issue industrial revenue bonds. Unfortunately, these restrictions would also apply to bonds issued for traditional public purposes, such as ports, mass transportation facilities, airports and bonds issued for charitable and educational organizations.

PSA supports the right of State and local governments to issue tax-exempt securities for public purposes in accordance with State law. However, we recognize that small issue IRB's have had an adverse impact on the market. Therefore, we have urged States to curtail their use. Our association believes that any change in Federal law should be limited strictly to small issue IRB's and should be directed toward the corporate beneficiaries of these financings.

PSA strongly opposes the administration's proposals to restrict tax-exempt bonds for exempt activities and charitable and educational purposes. The 1968 legislation establishing the current statutory provisions for municipal securities expressly recognized the public purposes achieved by the exempt activities listed in the statute. Moreover, these public purpose IRB's, which have built infrastructure and public works facilities already comply with public use requirements established by the Treasury.

These bonds have financed a wide variety of vital public purpose projects such as: construction of multifamily housing projects for low income families or the elderly; construction of hospitals owned by charitable, nonprofit organizations; and port development through dock and wharf construction and boat channel dredging.

We believe that they should not be affected by any legislation to restrict small issue IRB's.

In closing, we would like to reiterate that the adverse effects on the municipal securities market of last year's tax revisions pale by comparison to the devastating consequences of this year's proposals. Participants at all levels of this market will suffer, most particularly State and local issuers and the investor. We urge the committee to preserve this market, which has served this country's State and local governments so well over the years.

Thank you.

[The prepared statement of Mr. Clyde follows:]

STATEMENT OF

LARRY F. CLYDE

CHAIRMAN OF THE PUBLIC SECURITIES ASSOCIATION

INTRODUCTION

Mr. Chairman, and members of this distinguished Committee, I appreciate this opportunity to present the views of the Public Securities Association (PSA) on the tax proposals directly affecting the public securities markets contained in the Administration's Fiscal Year 1983 Budget. PSA is the national trade association representing banks, dealers and brokers that underwrite, trade and sell state and local government securities and U.S. government and federal agency securities. Our membership of approximately 300 firms collectively account for approximately 95% of the Nation's municipal securities industry underwriting and trading activity. In addition, 34 of the 35 primary dealers in government securities, as recognized by the Federal Reserve, are PSA members.

We expect to continue both underwriting and distributing state and local government securities whether or not the Congress enacts the Administration's tax proposals. Accordingly, we believe we can be reasonably objective in appraising the capital market and economic effects of these proposals insofar as they relate to state and local government securities.

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* Mr. Clyde, who is Executive Vice President of Crocker National Bank, is Chairman of the Board of Directors of the Public Securities Association.

My remarks will address the effects on the public securities market of three particular tax proposals contained in the Reagan Administration's 1983 Budget. These proposals involve creating a new corporate minimum tax which would include as a "special deduction" the tax deduction claimed by a bank or other financial institution for interest paid on deposits to the extent it holds tax-exempt state and local government securities; the proposal to add a new set of conditions to the use of tax-exempt bonds for what were heretofore considered traditional public purpose activities and, the proposal concerning withholding on interest and dividends.

The Public Securities Association is deeply concerned with the implications of these proposals particularly as they bring into question the very future of the concept of the tax exemption for state and local government securities. We are also disturbed that these proposals are being debated at a time when states and local governments are being asked to shoulder increased fiscal responsibilities.

PSA shares this Committee's concern over the size of projected budget deficits; however, we believe that the Congress must seriously consider the implications of these proposals to the extent that they represent an abrogation of the Constitutional doctrine of reciprocal immunity. We recommend that the Congress carefully consider the devastating impact of these tax revisions on the ability of state and local governments to meet their financial objectives by borrowing in the municipal securities market.

The municipal securities market has served this country's state and local governments well over the years by providing low cost capital to meet the needs and general welfare of all their citizens. We believe that these proposals now bring into question the very future of this historically independent marketplace. A brief overview will help you gauge the importance of this market to our capital market system.

OVERVIEW OF THE MUNICIPAL SECURITIES MARKET

At present, the municipal bond market is the fourth largest sector of the domestic capital markets, accounting for approximately $356 billion, or just over 10% of all medium and long-term securities outstanding. The importance of this market may not only be measured by its size, but also by its social utility: the broad access it provides state and local governments to raise funds in the public capital markets at reasonable rates and in an expedient and orderly fashion. The funds raised in the capital markets by state and local governments are used to finance the cost of such critically important projects as schools, highways, ports, bridges, hospitals, airports, mass commuting and parking facilities, and sewage and waste disposal facilities.

The new issue market for municipal securities for 1981 reached $85.2 billion, surpassing 1980's record 12-month volume of $76 billion. The sensitivity of the market to the present interest rate environment is evidenced by the increased use of short-term financing. In 1981, short-term volume increased to $37.7 billion, up 35.8% from 1980, an all time record. Annual average borrowing costs stood at 10.77% compared with a 1980 annual average of 8.66%.

Traditionally, yields on municipal securities have ranged from 65% to 70% of taxable securities with equivalent rating and maturity. During 1981, however, the spread between 20-year AAA corporate bonds and 20-year AAA municipal bonds narrowed to 73.4%. This compares to a spread of 65.6% for 1980. Even more disturbing, however, is the fact that during December, 1981, the spread narrowed to 82.2%. Although this unprecedented reduction in the spread is not expected to be permanent, it does indicate that the municipal market is faring worse than other capital market sectors under the current strain of high interest rates.

Despite the recent price advance, the upward pressure on rates in the municipal securities market appears likely to continue in 1982 as the supply of securities will remain high relative to softening demand by investors. In addition, many of the tax law changes adopted as part of the 1981 Tax Act continue to have adverse effects on the market. These changes include the ill-advised, tax free "All Savers Certificates," the reduction in the maximum tax, and the incentives for leasing and retirement accounts. However, the negative effects of last year's tax revisions pale by comparison to the likely impact of the Administration's new set of proposals. Participants at all levels of the market will suffer: the issuer, through overly restrictive prescriptions on the type of tax-exempt bonds it may issue, the corporate bank investor, through indirect taxation of its holdings of municipal securities and the municipal securities dealer, through added reporting and withholding requirements.

Let us first examine the new corporate minimum tax and its likely effects on the municipal securities market.

THE IMPACT OF THE CORPORATE MINIMUM TAX ON THE MUNICIPAL SECURITIES MARKET

The Administration has proposed a new alternative corporate minimum tax to replace the current add-on minimum tax. The new alternative minimum tax on "corporate profits" in excess of $50,000 would be required to be paid only if it exceeds the regular corporate income tax. We will address only one particular provision of this proposal, which we believe, alone, will have a severe adverse effect on the entire municipal market.

The Administration has recommended that corporate profits be calculated by adding back to a corporation's taxable income a series of special deductions which include deductions presently permitted commercial banks and certain other financial institutions for interest paid on deposits where the corporation holds tax-exempt securities. The Treasury Department has stated that in determining the amount of interest deduction to be added to the minimum tax base, the corporation's total interest deductions will be allocated pro rata across its total investment portfolio.

The Public Securities Association is deeply concerned by the implications of this proposal, since it will significantly reduce the future participation of commercial banks as investors in tax-exempt municipal bonds and consequently will substantially increase state and municipal borrowing costs. We estimate that this proposal will cost state and local governments approximately $1 billion in the first year alone.

Of even greater importance is the fact that this proposal represents an indirect form of taxation on the obligations of state and local governments. This would represent an irreparable breach of the Constitutional and historic wall of reciprocal immunity which heretofore has generally prevented state taxation of federal debt obligations and, conversely, federal taxation of state and local obligations.

Maintaining commercial bank demand for municipal securities is critical to the future of the municipal securities market. Of the $356 billion of municipal debt outstanding at the end of 1981, we estimate that commercial banks held approximately 42% or $150 billion. It is clear that any proposal which severely reduces the net after-tax yield and consequently the net income value of these instruments for banks will have substantial effects on the entire municipal market.

With the expanded opportunities for sheltering income through alternative investment vehicles, and their increased sensitivity to price volatility, it is reasonable to anticipate that this proposal will result in an immediate and substantial diminution in commercial bank investments in municipals. This could undermine the future viability of the municipal market. It will undoubtedly drive this market's largest single purchaser to other available forms of investment.

We are also deeply concerned with the proposal's retroactive application to all outstanding tax-exempt securities held in the investment portfolios of commercial banks and other financial institutions. The investment decisions to purchase these securities were made years ago, under economic assumptions based on existing law, under which banks accepted relatively low rates of return on their investments in municipal securities. We believe that the retroactive application of this proposal which will essentially change the tax law in effect when the municipal securities were purchased, will create uncertainty among all investors in these securities. It will force them to require a margin of safety against further retroactive tax intrusions by demanding higher rates on all new purchases of state and municipal securities.

Worthy of particular note is the fact that this proposal redefines bank deposits as a form of bank borrowing.

Traditionally, the tax law has not viewed the normal deposit taking functions of banks as forms of borrowings. This redefinition could have broader implications which go beyond the intention of the Administration in submitting this proposal.

It is critically important for this Committee to recognize that tax exemption if not a gift from the federal government. It is a quid pro quo for the acceptance of lower rates of return than the investor could obtain on alternative investments. An investor in tax-exempt bonds has historically accepted bonds which offer significantly less interest income than he could receive from taxable securities. This represents the consideration he has paid for the tax exemption. Thus, in a very real sense, and certainly in terms of equity, the investor in tax-exempt bonds has already paid a tax and has paid it in advance.

From the perspective of state and local governments, this proposal represents another in a series of recent federal actions which are continuing to promote upward pressure on municipal borrowing rates. For example, the fundamental realignment of federal, state and local responsibilities being proposed under the Administration's "New Federalism" initiative, the severe budget reductions in federal assistance to state and local governments and several provisions of the 1981 Tax Act, taken together, are exacerbating the burdens of high interest rates on the municipal securities market.

To the degree that interest on tax-exempt municipal securities is compromised as part of a minimum tax proposal, all state and local governments will be required to pay more for their future borrowings. These added borrowing costs mean higher state and local taxes for all citizens. In fact, the reaction of the municipal market, in all likelihood, will be so severe that the increases in state and local taxes could more than offset any federal revenue gain.

The municipal bond market already experienced similar results when minimum tax legislation that included a tax on municipal interest passed the House of Representatives as part of the Tax Reform Act of 1969. By late August, 1969, the market for municipal bonds suffered a severe dislocation and near collapse. Many local governments were unable to issue bonds at rates within the maximum limits fixed by their controlling state finance laws. It was also difficult to find realistic bids for bonds which investors wanted to sell. We certainly do not want to witness a repeat of the 1969 experience, particularly now, when the municipal market is already suffering under the strains of unprecedented interest rates.

We also understand that Congress is seriously considering broadening the current minimum tax proposals to include interest earned on municipal securities by corporations and individuals. In our opinion, this more direct form of taxation of state and municipal securities would not only be unconstitutional, but in tandem with the proposed corporate minimum tax would devastate the entire municipal market.

In conclusion, PSA opposes imposition of a direct minimum tax upon the interest income from state and local government securities. PSA believes that any such action would cause severe problems in the marketing of such securities and would increase the borrowing costs of state and local governments. We also oppose the indirect tax on municipal bond income proposed by the Administration. We believe that it would effectively remove commercial banks from the municipal market and would cause uncertainty over the status of the tax exemption among all investors.

We have already described the reasons why we believe that the Administration's minimum tax proposal will raise state and local borrowing costs. Let us next examine the set of prescriptions that are recommended in the use of tax-exempt bonds for private activities. PSA believes that this proposal, to the extent that it restricts industrial revenue bonds for "exempt activities" will handcuff state and local issuers and prevent them from meeting the public needs of their citizens.

THE ADMINISTRATION PROPOSAL TO RESTRICT PRIVATE AND PUBLIC PURPOSE INDUSTRIAL REVENUE BONDS

The Administration's proposal relating to industrial revenue bonds would restrict (1) small-issue industrial revenue bonds (IRBs), (2) IRBs used to finance specified exempt public purpose activities, and (3) financings for non-profit hospitals, educational institutions and student loans.

The original IRB statute was adopted in 1968 as part of the Revenue and Expenditure Control Act of 1968. The Act contains a general rule rendering the income on all IRBs taxable and then establishes several categories of tax-exempt industrial revenue bonds. A tax-exempt small issue IRB can be issued for up to $1 million and alternatively, for up to $10 million subject to capital expenditure limitations. The other exceptions in the present statute are for "exempt activities" and certain charitable and other non-profit institutions. Contained in this list of specifically enumerated activities, are projects for public use and benefit which historically have been undertaken by state and local governments.

The Administration has now proposed adding the following conditions to the use of all types of IRBs regardless of their ultimate use:

1) The restrictions generally would apply to what the Administration has characterized as "private purpose" bonds issued after December 31, 1982.

2) The costs of depreciable assets financed with the tax-exempt bonds could be recovered only by using straight line depreciation over an extended recovery period.

3) Small issue IRBs would be limited to small businesses (i.e., a company with capital expenditures of less than $20 million over a six-year period and no more than $10 million of IRBs outstanding).

4) Restrictions on permissible yield from investment of the proceeds of the obligations would be extended to reserve funds and funds held during the temporary construction period.

5) Each bond would be required to be in registered form, and information concerning the issuance of the obligations must be reported to the IRS.

6) After December 31, 1985, the state or local governmental unit would be required to make a contribution or commitment to the facility financed equal to one percent of the face amount of the bonds.

7) The highest elected official or legislative body would be required to approve the bonds after a public hearing.

Before discussing PSA's specific comments on the Administration's proposal, it may be helpful to present the Committee with our policy position on small issue IRBs.

> The Public Securities Association supports the right of state and local governments to issue tax-exempt securities for public purposes in accordance with state law. However, PSA believes that small issue industrial revenue bonds have had an adverse effect on the municipal securities market, and urges that state and local governments take positive steps to curtail their use.
>
> Our Association opposes federal legislation which would restrict the right of state and local governments to determine the public purposes for which bonds can be issued. We believe that any federal action concerning small issue IRBs should be limited only to the tax treatment of direct, private beneficiaries of the proceeds of small issue IRBs.

We believe the Administration's proposed choice between ACRS and tax-exempt financing is appropriate if, and only if, it is limited to direct private beneficiaries of small issue IRBs. we also believe that the same proposal as applied to "exempt activity" and charitable purpose tax-exempt bonds represents a form of restriction which compromises the rights of state and local governments to issue tax-exempt securities for traditional public purposes. We believe that these public purpose industrial revenue bonds, which have played a vital role in establishing and maintaining infrastructures and public works facilities for general public use and benefit should not be subject to the restrictions imposed by the Treasury. Recent controversy over IRBs has been limited to small issue financings. Any changes in federal law should be limited to that area.

The 1968 federal legislation establishing the current statutory provisions for state and local government securities contained such a broad definition of "industrial development bond" that any significant private involvement in a project could result in IRB status. Congress recognized, however, that these projects are financed in the municipal market because they involve facilities for public use and benefit or extensions of publicly used facilities. Consequently, Congress decided that tax-exempt financing of those projects was necessary and appropriate and should not be restricted in order to permit state and local governments to fulfill the general needs of the public. Special categories were therefore established to continue this financing for traditional public purpose projects, including airports, docks and wharves, mass commuting and parking facilities, sports or convention facilities, housing projects, water, electric, sewage and waste disposal facilities as well as for certain charitable and non-profit organizations.*

Today, municipal financing for such projects is essential for the construction or redevelopment of infrastructures and facilities necessary for the social and economic well being of all citizens. The fact that private parties may operate or otherwise benefit from these facilities simply reflects the historic practice of state and local governments in providing public works necessary to support and maintain residential communities and commercial and industrial development.

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* In the 1968 statute Congress also authorized tax-exempt financing for pollution control facilities owned by private corporations. Although there is a public benefit associated with a cleaner environment, the proceeds of tax-exempt pollution control bond issues generally benefit a single corporate polluter. This exemption was added by Congress to the 1968 legislation to assist corporations in meeting federal pollution standards. PSA has a policy position in support of eliminating the use of tax-exempt municipal securities to finance pollution control facilities which are not owned and operated by local governments. PSA believes that the federal government should adopt other ways of assisting private industry in its efforts to meet federal environmental standards.

Public purpose is a continually evolving concept. If state and local governments are to accept increasing responsibility for meeting their own needs under the New Federalism, the private sector will be a necessary partner in such projects. This objective will be seriously impaired if Congress enacts the Administration's proposals which will jeopardize the flexibility of states and localities in choosing, consistent with determinations of public purpose under state law, the types of public works they will finance.

The economic needs of our states are far too varied and complex for the Treasury's proposal restricting exempt facility financing. This is clearly demonstrated by examining the following examples of financings to which these proposals would apparently apply:

1) A county agrees to issue bonds to extend public sewer lines to serve several private businesses;

2) A rural municipality issues bonds to build and equip a bus terminal which the private bus line will operate;

3) A city seeks to finance construction of new counter and hangar space at a municipal airport in order to bring commercial passenger service into the area;

4) A private company agrees to purchase 30 percent of the output from a certain power facility to be financed (the remaining output will be used by several municipal purchasers); and

5) As part of an urban renewal project, a city issues debt to finance construction of a parking garage which will be leased for operation by a private company.

These situations, and many others, represent what today are garden-variety public works projects. There can be little doubt, however, that Treasury and IRS would treat these cases as "private purpose" financings subject to the proposed new limitations.

ACRS Versus Straight Line Depreciation

The Treasury has proposed that a private participant be required to choose between the new, rapid depreciation system

(ACRS) and tax-exempt financing for project facilities it may be entitled to depreciate. We believe that given this choice, most private parties would decide to use ACRS. In effect, therefore, the proposal dictates that state and local governments may not issue debt to finance such projects unless the private participants compromise their own economic interests. Since tax-exempt financing will be an important factor in the private decision making process, the result in many cases will simply be to prevent the private participation necessary to make the state or local project economically viable.

In addition to requiring this "choice" (which in our view is not really a choice) between tax-exempt financing and ACRS by private participants in public projects, the Treasury Department proposal would impose other unwarranted restrictions on state and local public purpose projects financed with municipal bonds.

Arbitrage Restrictions

PSA opposes the broad new restrictions on investments of proceeds from the sale of tax-exempt state and local government securities proposed by the Administration. These new "arbitrage" restrictions would apply to any facility which the federal government did not regard as wholly public in nature and thus would adversely affect the whole spectrum of exempt facilities financings, as well as financings for tax-exempt hospitals, educational institutions, etc.

When Congress adopted the Tax Reform Act of 1969, it eliminated the statutory tax exemption for arbitrage bonds and imposed strict limitations on the investment of proceeds from the sale of municipal bonds. Arbitrage bonds are defined as bond issues in which the proceeds are used to acquire taxable securities that produce a materially higher yield than the yield on the tax-exempt bond issue. Once determined to be arbitrage bonds, securities are no longer tax-exempt.

The original arbitrage statute, however, included certain exceptions which expressly authorized unrestricted investment of bond proceeds (1) for a temporary period pending use in the project, or (2) in a reasonably required reserve or replacement fund not exceeding 15 percent of the bond issue. The Administration is now seeking to have both of these provisions repealed for the broad range of public purpose tax-exempt bonds issued to finance projects which the Treasury has mislabeled as "private activities."

PSA opposes these drastic changes in the arbitrage restrictions for the following reasons:

--The new restrictions will adversely impact a great number of projects which clearly provide public benefits;

--The restrictions will create shortfalls in amounts needed in connection with these projects. The shortfalls would have to be made up through unnecessary additional borrowing which, in turn, would swell the volume of municipal debt and further increase the costs of financing needed projects;

--The restrictions will be burdensome, counterproductive, and inconsistent with the efforts by the Administration to encourage greater self-sufficiency on the part of state and local governments;

--To achieve compliance with the new restrictions, the construction or reserve funds for bond issues would generally have to be invested in special U.S. Treasury securities bearing interest at substantially below market rates. The result would be pure subsidization of the federal deficit at the expense of state and local governments;

--The restrictions would involve a serious intrusion into the basic authority of state and local governments to determine whether projects serve public purposes;

--The current provisions represent Congressional recognition of the way in which municipal bond construction and reserve funds have traditionally been used.

Finally, the Administration has failed to demonstrate why it is necessary to reverse this sound and long-standing Congressional decision.

Registered Bonds

PSA opposes the Administration's proposal which would require that all tax-exempt bonds for "private activities" be issued in registered form. There are several reasons why we do not support this recommendation:

--First, such requirement could create a two-tiered municipal securities market, the first tier consisting of outstanding bearer securities and the second tier consisting of new issue registered securities. The creation of a two-tiered system would fundamentally alter the structure of the municipal securities market and even more importantly, could increase borrowing costs for state and local governments seeking to raise new capital. We anticipate that issues of smaller size will be particularly affected.

--Secondly, registration could add operational and administrative burdens to municipal securities dealers which could slow the velocity of trading activity thus increasing the risk of taking positions in the market and further stimulating price volatility.

--Lastly, efforts to establish automated systems of municipal security clearance and comparison are still in the trial stage as are current efforts to establish a municipal security depository environment. Their establishment and effective operation are some time away. For these reasons, we believe that benefits to the federal government resulting from a registration requirement at this time would be outweighed by the costs to state and local governments and the burdens it would place on the market.

Consequently, PSA believes that it would be particularly inappropriate, at this time, for the federal government to require that state and local governments radically change the manner in which they issue municipal securities. Moreover, irrespective of current economic conditions, we believe that market participants and not federal tax law should determine the most efficient manner to issue and trade municipal securities.

One Percent Local Contribution

The Administration has proposed that, after December 31, 1985, the local governmental unit in which a project financed with tax-exempt bonds is located, make a financial contribution or commitment to the facility equal to one percent of the face amount of the bonds.

PSA is concerned that this proposal would adversely affect tax-exempt financing in many states. Over 20 states have Constitutional or statutory prohibitions which preclude the making of loans, the extension of credit or the granting of abatements or exemptions to any type of private corporation. For this very reason, many states created independent authorities and public benefit corporations which are established to facilitate the promotion of economic development and to meet the public needs of their citizens. The enactment of this proposal would force states to either amend their Constitutions (a very formidable task) or eliminate the use of tax-exempt financing for "private activities" after 1985. This is an undesirable result and certainly one which is beyond the stated intent of the Administration in recommending this legislation.

WITHHOLDING ON INTEREST AND DIVIDENDS

The Administration has proposed that a flat rate tax of 5 percent be withheld from interest and dividend payments made to individuals. The reasons for PSA's opposition to this proposal may best be summarized by reference to the resolution adopted by the Committee on Finance in 1980 (S. Con. Res. 92)(Senate Report No. 96-863, 96th Congress, 2nd Session, July 23, 1980), which reads in pertinent part:

> Since the current system of withholding on wages and salaries was initiated, there have been several proposals for extending withholding to interest and dividend payments. The Committee has never approved such proposals in the past and it is the judgment of the Committee

that it will not approve any such proposal now. The Committee is concerned that the proposal to withhold income tax on interest and dividend payments could work hardships on those individuals least able to afford them, such as retirees who depend on social security and dividend and interest income. In addition, the Committee believes that the proposed exemptions from withholding, which are designed to make the system more equitable, would make the withholding system unacceptably cumbersome and costly to administer. Because of these concerns, the Committee has reported this resolution which affirmatively states that it is the sense of the Congress that the enactment of a withholding tax on interest and dividend payments would be detrimental to the economic well-being of the United States.

The Administration's proposal would impose a withholding requirement for payments of interest to all individuals who purchase bills, notes and bonds issued by the U.S. Treasury and federal agency obligations. The Committee should note that individuals have played an increasingly important role in the government securities market and can be expected to in the future. We estimate that "households" now hold over $200 billion of outstanding Treasury debt.

We are all keenly aware of the enormous borrowing requirements of the Treasury in the years ahead, particularly since it will be seeking to finance projected deficits which may exceed one quarter of a trillion dollars between now and fiscal year 1985. Therefore, it does not seem logical to be promoting legislation whose effect will be to drain investable funds from the household sector of investors at a time when they will be increasingly relied on to finance the federal debt.

Implementation of the Administraton's withholding proposal would also result in significant operational costs for the dealers and dealer banks in government securities which would act as withholding agents for the Treasury. Unlike interest on savings and corporate dividends, there is currently no information reporting system in place for interest earned on government securities. The basic record-keeping system for most dealers in government securities consists of customer confirmations of purchases and sales. The costs of implementing withholding and processing exemption certificates will have to be passed on to investors, reducing their return on investments.

For these reasons, PSA opposes the withholding on interest and dividend proposal. We believe that taxpayers who save and invest are promoting the goals of the Administration's overall economic recovery plan and therefore should not be subjected to additional withholding requirements.

Conclusion

PSA believes that the Administration's tax proposals, if enacted, could prove to be the death knell of the municipal bond market. The inclusion in a new minimum tax of an indirect tax on municipal bond holdings of commercial banks, the largest single investor in municipal securities, will substantially reduce, if not discontinue, their purchasing of new issue municipal bonds; at the same time, the retroactive application of this tax law change could cause them to sell off much of their portfolio investments in municipal securities. This will drive bond prices down, force yields up, and make it increasingly burdensome for state and local governments to borrow to finance their growing needs.

If the rules of the game can be changed in relation to outstanding bonds in the hands of corporations, other investors will logically conclude that the rules could be changed for them as well. Therefore, they will demand a margin of protection against further deterioration in the value of securities that they hold, adding further upward pressures on state and local borrowing costs.

The Administration's restrictions in the area of public purpose exempt activity financing, if enacted, will also have a disruptive effect on the market. These broad and overly restrictive requirements will adversely affect an area of financing which, by all traditional definitions, has fulfilled public need and public purpose. There has been no demonstration of any need to make corrections outside of the current provisions for small issue IRBs.

In closing, we would like to reiterate that the adverse effects on the municipal securities market of last year's ill-advised, tax-free "All Savers Certificates," the reduction in maximum tax rates, and the incentives for leasing and retirement accounts, pale by comparison to the devastating consequences of this year's set of proposals. Participants at all levels of this market will suffer, most particularly state and local issuers and the investor. We urge the Committee to preserve this market, which has served this country's state and local governments so well over the years.

Thank you.

Senator **Long**. Thank you very much, gentlemen.

Statement
of
SENATOR JOHN C. STENNIS
to the
COMMITTEE ON FINANCE, UNITED STATES SENATE
Relative To
TAX-EXEMPT INDUSTRIAL REVENUE BONDS

Mr. Chairman and Members of the Committee, I appreciate very much being granted the opportunity to submit this statement to you. The purpose of this statement is to discuss the use of tax-exempt industrial development bonds by state and local governments. Your Committee has, of course, been studying this matter in considerable detail for some time.

It is a matter of pride with me that Mississippi, in 1936, was the first state to pass legislation authorizing local governments to issue tax-exempt bonds for industrial development purposes. It was the pioneer in this field. The issuance of these bonds was a part of Mississippi's broader effort to bring industrial development to a depressed agricultural economy.

The original purpose of these bonds was to promote industrial development and to strengthen the manufacturing base of a depressed rural economy. While there have allegedly been abuses of these bonds in other states, I do not believe that this can be said of Mississippi's program.

From the program's inception to the present, my State has exercized careful control over the use of these industrial development bonds. Their use has been limited to manufacturing, processing and warehousing.

Mississippi, I believe, operates a model program. Each issue must be approved both by the local government, through the city council or the county board of supervisors, and by the State Board of Economic Development. These bodies consider each potential issue very carefully and do not hesitate to reject an issue if it does not substantially further the program of stimulating economic development.

Industrial development bonds have been a very important development tool in Mississippi. While our State is still one of the poorest in the Nation, our carefully administered industrial development bond program has been absolutely crucial to our economic growth and development. A great deal of the progress which has been made in Mississippi in increasing manufacturing jobs can be credited to industrial development bond financing. These bonds have provided the means for capital formation which has not been otherwise present and have helped create jobs in industry where none existed before.

Without the availability of industrial development bond financing, I am convinced that many of the new plants which have located in Mississippi would not have been constructed. Let me give a few figures. In the years 1979 and 1980, there were 117 projects financed with small-issue industrial development bonds in Mississippi. These projects represented a capital investment of about $243 million and created over 9,000 new jobs with an estimated annual payroll of almost $110 million. I think it is safe to say that the majority of these new jobs would not have been created if financing with tax-exempt industrial development bonds had not been available.

Other states have recognized the value of these bonds in promoting economic growth. I believe that today some 48 states allow some form of tax-exempt small-issue industrial development bond financing. Clearly there is no inherent regional bias in the program as it now exists. This is made clear by the fact that the National Governors' Conference strongly opposes the Administration's recommendations. Ten states follow Mississippi in allowing the bonds to be issued solely for industrial or warehousing purposes. Unfortunately, some of the states which have authorized the issuance of such bonds have abused the program and provided for the issuance of these bonds for non-industrial and non-essential purposes.

The Administration has proposed and this Committee has considered limitations on the issuance of industrial development bonds which would have such a negative impact that they would probably kill the industrial development bond program. I believe that it would be a serious mistake to adopt the Administration's recommendations or any major portion of them.

I want to stress to this Committee in all candor that the future industrial and economic development of my State is, like that of many others, dependent on the availability of tax-exempt industrial development bond financing. This industrial development is absolutely necessary to the welfare of my State and its citizens. Over the years, in Mississippi and elsewhere, increased industrial development has proven to be the most successful method of stimulating the economy, reducing the national trade deficit, creating new jobs, and stimulating the growth and development of the Nation.

I do not have to point out that this country is now in a serious recession. Economic development programs are needed now as much as or more than they ever have been. Industrial revenue bonds, and small-issue industrial development bonds in particular, are effective and absolutely essential development tools.

I am greatly distressed that this important tool for industrial development is now in jeopardy. The Administration has proposed severe restrictions. In fact, as I have said, they are so severe that, if they are adopted as proposed, the impact will be to eliminate the issuance of industrial development bonds in the future. Although I can recognize the need for legislation which corrects any abuses which may occur in the industrial development bond program, I believe that such legislation should preserve the use of industrial development bonds for their fundamental purpose, which is industrial development.

I hope that this Committee will agree with me; that it will reject the legislation proposed by the Administration; and that instead it will recommend legislation which will provide stability and certainty in the tax-exempt industrial bond market. Such stability and certainty does not exist at present because of the legislation the Administration has proposed, and which this Committee is now considering, and because revenue rulings which have been adopted by the Department of the Treasury, such as Revenue Ruling 81-216, which contain severe restrictions on small-issue industrial revenue bonds and, as a result, close the door on many bond issues.

I again express my appreciation to the Committee for the privilege of being allowed to present this statement. I hope that it will not recommend legislation which would eliminate or severely restrict the industrial development bond programs of the States.

Senator Long. I have a question or two here. One of the aspects of PSA decisions today is for State and local governments to curtail the use of small-issue bonds. A New York Times article from last November reported that "more than 60 percent of the members that the PSA surveyed believe that the States could not solve the problem." Do you still think that the States' level of bond reform is realistic, especially since there is no assurance that neighboring States would be similarly responsive to reform?

Mr. Clyde. Well, Senator Long, we think that that would be the ideal solution to the problem. But, obviously, some of our members feel it might be impractical. I can simply state our position which was that we did call for State and local governments to curtail their financing. However, we acknowledge that if reductions in this kind of financing came through Federal legislation, that would urge the Congress then to direct the impact of the legislation to the beneficiaries in the form of disallowing interest deductions on the interest paid on these tax-free bond issues.

Senator Long. Well, let me just tell you gentlemen that there is a lot of concern about this legislation. And although we do not have good attendance in this committee today, we have had various petitioners from all over the whole country who have contacted the Senators about the various aspects of this problem. And I would urge you to do likewise. The whole committee is not here—and perhaps we could send somebody down the hall to find somebody—as those interested on tax policy do follow the hearings very closely. And we will alert the Senators of these problems.

That concludes this session this morning. And the committee will stand in recess until 9 a.m. tomorrow.

Thank you very much.

[Whereupon, at 11:44 a.m., the hearing was recessed.]

[By direction of the chairman the following communications were made part of the hearing record:]

cha California Hospital Association
1023 12th Street Sacramento, CA 95814 916/443-7401

Statement of the California Hospital Association
Before the
Senate Finance Committee
FY 1983 Medicare and Medicaid Budget Proposals

On behalf of the 530 member hospitals of the California Hospital Association, we would like to present our views and recommendations on the proposed Fiscal Year 1983 budget recently submitted to the Congress by the President. Our comments will be confined to a number of issues pertaining to the Medicare and Medicaid programs which fall within the jurisdiction of this Committee.

We recognize that increases in federal outlays for the Medicare and Medicaid programs are placing significant strains on the budget, which is a proper concern of this Committee. At the same time, and as we have stated before, arbitrary cuts in these critical programs are disruptive to the financial integrity of our hospitals and threaten the continued access to health care services of the beneficiaries of these programs. "Quick fixes" only continue the shift of Medicare costs to other purchasers of care, providers and patients.

We first call your attention to several proposed Medicare changes included in the Administration's budget. Perhaps the most deleterious proposal, and certainly one of the most inequitable, is the across-the-board reduction of hospital inpatient reimbursement by 2 percent.

While the administrative simplicity and savings certainly are appealing, it is these very characteristics which make this proposal inequitable and counterproductive.

An across-the-board payment cut is based on a false premise that all hospitals have similar Medicare patient loads, and therefore, would [illegible] affected by the cuts. The numbers and types of Medicare patients vary greatly among hospitals: the impact of a 2 percent cut would also vary. This change would impact the greatest on those hospitals which serve large portions of the community's aged.

Equally disturbing are the disincentives for efficiency and economy which a 2 percent payment cut would entail. Hospitals which sought further savings through more cost-effective administrative and delivery reforms would nevertheless be "rewarded" with the same 2 percent cut as hospitals that make no such effort. Further, there would be an incentive to increase Medicare utilization to partially offset the 2 percent cut because marginal costs--the costs of added services--are less than average costs in such institutions.

If this inequitable and counterproductive uniform reimbursement cut is accepted, we estimate it will add between $65 and $85 million to the current $500 million pool of Medicare's and Medicaid's unreimbursed hospital costs in California. In order to remain economically viable, hospitals must seek recovery of this shortfall from their private paying patients and other third party payers.
In California it is increasingly difficult to identify other sources to help finance the care provided Medicare beneficiaries. Hospitals with heavy Medicare, Medicaid, and non-paying patient loads have

virtually no place from which to recover such unmet costs. Thus, a cut of this magnitude would result in service and staffing cutbacks in hospitals, with a corresponding deterioration in access and quality as they seek to reduce their expenses--even though such actions cannot eliminate the deficits that would be incurred under the proposal.

There are several other Medicare proposals which would have results quite counter to program efficiency and beneficiary access to quality hospital care. Specifically, we are seriously concerned with the proposed repeal of the waiver of provider liability. We believe that in the exercise of professional judgment and in cases where due care has been taken, providers should not be held liable for the costs of services that in hindsight are judged by Medicare to be uncovered or unnecessary. There are presently mechanisms to assure that providers who consistently exercise poor judgment or who have unacceptably high denial rates are disciplined and made accountable. We believe these procedures are sufficient to maintain program integrity and to minimize the burden on administration. This is a far better approach than a return to the practice of demanding patient deposits when the hospital is uncertain as to what services the patient will be found to require in the course of his stay.

We understand that repeal of the waiver of provider liability is related to the development of a new utilization review program not yet described but presumably to be operated by carriers and intermediaries. If the proposed program relies on a system of retrospective claims review similar to that which existed prior to the PSRO program, we would like to record our strong objections. Repeal of the waiver of liability would facilitate the application of penalties under such a program, but it would also permit retrospective reviews to determine whether to pay a hospital that must make its judgment of the needs of a patient when the patient appears in pain at its front door.

Two other reimbursement proposals in the Administration's Medicare recommendations are of special concern to the members of CHA. Both proposals involve the methods for reimbursing physician services in the hospital setting. First, the Administration proposes that payment for the services of hospital-based physicians (generally radiologists and pathologists) be handled in the same manner as for all other physician services. We would like to point out that present procedures which permit such physicians to receive 100 percent of the Medicare reasonable charge, rather than 80 percent of such charges, were designed by the House Ways and Means Committee in 1967 to improve administrative efficiency by allowing hospitals to combine these bills with the Medicare cost billings for other services in the departments where they perform their services. Current policy reflects the nature of the arrangements which exist between hospitals and physicians whose entire practice is located in the hospital setting. We believe these combined billing procedures have simplified reimbursement procedures, and that the recent requirement for physicians to accept assignment for these services argues persuasively for the retention of these procedures.

The second physician reimbursement provision would reduce the physician charge limits for services provided in hospital outpatient departments on the theory that physicians do not bear the overhead costs which are normally incorporated in their fees for services in their office practice. While the logic of this argument is compelling, in certain hospitals the fees of ambulatory services teaching physicians sometimes support the costs of these services which are not fully met by Medicare and other payers. In these circumstances this proposal could have a very deleterious effect on primary care services provided by hospital outpatient departments. Furthermore, we do not expect physicians to have lower fees for hospital outpatient services than for office services. If they have uniform fees, they are likely not to accept assignment of payment under Medicare and the burden on patients for payment is likely to increase.

We oppose the provision for a change in reimbursement provisions for private rooms. When Medicare was enacted, it was recognized that bare cost reimbursement was insufficient to keep hospitals viable. Therefore, hospitals were permitted to profit when a patient, on his own volition, uses a private room. Under the proposal, essentially the entire profit would go to Medicare. Medicare would be reimbursed more than cost in these cases.

We have also examined the other proposals included in the Medicare portion of the budget submission and we would like to recommend that extension of the Medicare tax and Medicare eligibility to federal employees be enacted. Significant numbers of federal workers ultimately achieve Medicare eligibility through working briefly in covered private employment or through the eligibility of a spouse. Applying the hospital insurance tax to federal workers would bring more equity into the financing of Medicare and give all federal retirees another choice of health insurance coverage.

We also want to endorse the proposal to require continued private insurance coverage of persons who continue working after age 65 in those instances in which the employer offers health insurance coverage to all other employees. This proposal could provide significant savings to Medicare and it would end what now amounts to a Medicare subsidy of private group health insurance which does not bear any of the costs associated with health services for the working elderly.

In general we favor policies which move toward the creation of a more cost-conscious health delivery system and a reduction in inappropriate and costly regulation. Some of the proposals in the Administration's Medicare package would serve to heighten the cost-awareness of providers and patients through the extension of co-payments and reduction in the scope of Medicare coverage. These initiatives address the demand for services and can be effective in addressing Medicare [illegible] cost increases.

At the same time, the Administration is reportedly considering an expansion of the current program of cost limits under Section 223 of P.L. 92-603. We have testified repeatedly that present routine cost limits under Section 223 have had an inordinately discriminatory impact on California hospitals. The Section 223 methodology does not take into account significant regional variations in Medicare hospital utilization. While the 223 cost limits are based on a comparison of hospital per diem costs, the classification of hospitals for comparative purposes does not reflect the significantly shorter lengths of stay, lower admission rates, and higher intensity of services which are characteristic of California hospitals.

The solution long proposed by the California Hospital Association is the regionalization of the Section 223 schedule of limits. The limits would be computed according to the current methodology but separately for each of the four census regions. This solution has the advantage of simplicity and conforms to the original intent of Congress expressed by the House Ways and Means Committee that limits should be "based upon comparisons of costs of covered services by various classes of providers in the same geographical areas" (House of Representatives Report No. 92-231, May 26, 1971, U.S. Code, Congressional and Administrative News, p. 5004 (1972). The total shortfall would be approximately the same as under the current system, but it would be distributed more evenly across various geographical areas.

The Health Care Financing Administration (HCFA) is presently considering expansion of these inequitable cost limits to total inpatient costs supposedly adjusted for individual hospitals case mix differences. We fail to understand how extending this inequitable program can be justified by any benefits to the Medicare program. Compounding the present problems in which Medicare has not differentiated its payments in accordance with appropriate regional differences among hospitals, the HCFA proposals will not allow for proper adjustment for differences among patients. In our view, this system will create disincentives and impose penalties on our institutions simply because they have markedly reduced Mediare lengths of stay and the costs of the Medicare program for its beneficiaries in California. We urge you to express your opposition to HCFA and to recommend that the present methodology be revised to reflect appropriate regional differences.

Discussion of Medicaid changes is also warranted. Preliminary estimates are that California would lose about $240 million in FY 1983 if the Administration's Medicaid changes are adopted by Congress. These reductions come on top of a conservatively-projected 18 month loss to hospitals of $358.7 million in cutbacks to the state's Medicaid program, Medi-Cal, if the budget proposals introduced by California's Governor Brown are enacted. California is facing a major fiscal crisis, and the Legislature will be forced to balance the state's FY 82-83 budget, as required by our constitution, by either draconian cuts in the Medi-Cal program, or by tax increases. These actions will come on top of a state-imposed (and federally-approved) 6 percent inpatient reimbursement limit during this fiscal year, which threatens to cost hospitals $54 million. Further reduction in federal Medicaid programs are intolerable. As with Medicare shortfalls, providers would again be forced to transfer those unreimbursed costs to the private sector wherever possible.

Even without the imposition of proposed federal Medicaid changes, the state budget proposed by Governor Brown contains no increase whatsoever for provider rates, including inpatient reimbursements, despite the staggering costs of inflation on all segments of the economy. That budget also proposes to eliminate all existing state statutory requirements for reasonable reimbursement of both inpatient and outpatient services. Thus, the state Department of Health Services will be able to continually reduce the provider reimbursement program to achieve whatever budget cuts are mandated by the Legislature and the Federal government. Providers are already being forced to limit their growing financial liabilities from public programs by withdrawing from participation in those programs. Actions such as those now being contemplated at the state and federal level will surely make such withdrawals a viable and often necessary survival strategy for more and more providers.

We are particularly concerned about further reductions in federal matching rates. Specifically, we oppose the Administration's proposal to lower this rate by 3 percent for all services provided to the medically indigent. For California this would mean an estimated loss of $20 million. Since the state's finances are in such a precarious condition, general revenue funds will not be obligated. Rather, the cuts will again fall directly on beneficiaries and providers.

From our experience in California, it doesn't appear likely that the Medicaid cost sharing requirements will have the Administration's projected impact on utilization. California's experiment with cost sharing in 1972 and the first half of 1973 did not produce any conclusive results. While an evaluation of the experiment noted reduced "overutilization," the study did not address the contributory effects of prior authorization requirements which were imposed before the experiment began. The evaluation also noted a decline in preventive care which raises the issues of increases in downstream utilization patterns of more intense and expensive modalities of care. In 1979, the Los Angeles County Board of Supervisors imposed cost sharing at the county's public clinics. Preliminary estimates indicated that for every dollar of program administrative costs only $.80 was returned. While cost sharing may have only negligible effects on utilization, we expect that it will substantially increase hospital bad debts and charity care. This will be most true for those hospitals serving a large volume of Medi-Cal beneficiaries. These mostly inner-city hospitals are least able to handle such losses since their private patient revenue base is so small. The Committee should also be sensitive to the possibility that such cost sharing requirements as the Administration proposes may, in fact, increase program costs due to increased utilization of hospital emergency departments.

As we seek to address the problems arising from the redefinition of the public commitment to provide access to needed, quality health care for the elderly and the poor, we are concerned with the increasing acceptance by public officials of a two-tier health delivery system. CHA has been supportive of the goal of extending access to health services without regard to economic status. We see this goal being assaulted through arbitrary policies at both the state and federal level. Nevertheless, we believe that equitable and reasonable methods for financing the care provided under Medicare and Medicaid can be developed which do not compromise the enormous progress which has been made in bringing quality health care to all our citizens.

STATEMENT OF THE
HEALTH INSURANCE ASSOCIATION OF AMERICA
and the
AMERICAN COUNCIL OF LIFE INSURANCE

on

COST SHIFTING

PRESENTED BY

BURTON E. BURTON

BEFORE THE

SENATE COMMITTEE ON FINANCE

March 12, 1982

My name is Burton E. Burton. I am Senior Vice President of the Aetna Life and Casualty Company. I appear today on behalf of the Health Insurance Association of America and am joined in this statement by the American Council of Life Insurance.

Any enterprise, if it is to survive, must recover the costs of producing goods and services. Both fixed and variable costs must ultimately be reflected in the prices consumers pay. If one segment of a business suffers losses, then these losses must be offset by gains elsewhere. Otherwise, the entire enterprise will fail.

Hospitals, physicians, and nursing homes are no exception to this rule. Federal and state governments unfairly restrict their payments to health care providers, paying only part of the hospital costs of Medicare and Medicaid patients. When the government refuses to pay its full share, everyone else must pay more. Costs not covered by Medicare and Medicaid for their patients must, therefore, be recovered from private patients. It is, in effect, a hidden tax on sickness, levied on a hospital's non-government patients to pay those hospital expenses not paid by Medicare.

Despite widespread concern about rising health care costs, little attention has been focused until recently on the practice of cost-shifting from the public to the private sector.

This is how it works. Under the payment formulas established by the Health Care Financing Administration (HCFA) of the Department of Health and Human Services, certain hospital costs are not recognized. These include:

- The bad debt and charity costs incurred in treating patients who do not pay their bills.
- Certain equity capital requirements necessary for replacement and addition of facilities and equipment.
- Certain hospital educational and research costs.

At the same time, the government has progressively tightened its regulations for determining reimbursable costs. Section 1816 of the Social Security Act states that "reasonable cost shall be determined by regulation which may provide for the establishment of limits on the direct or indirect overall incurred costs . . . to be recognized as reasonable." These limits have been repeatedly lowered. As a result, the "hospital payment differential," that is, the difference between what Medicare and Medicaid choose to pay and what private sector patients pay, continues to grow year by year.

Mr. Chairman, the Congressional Budget Office last year stated that Medicare pays, on the average, 16% less than the average non-government patient. This, as troublesome as it is, of course, understates the problem in many areas. I can only call your attention to the man who drowned in the river which was only one foot deep -- on the average.

We believe strongly that, if a hospital has two patients, side by side, receiving the same care, in identical circumstances, it should receive the same payment regardless of who the payor is.

The situation is growing worse, not better. From 1975 to 1979, the differential rose from $12 to $41 per adjusted patient day, an increase of 242 percent. Based on this rate of growth, the difference will rise to $140 per adjusted patient day in 1983.

Stated another way, on an average daily basis in 1979, Medicare payments were $198 while private patients were charged an estimated $239 for the same service. Overall, the shortfall in government payments increased from $1.1 billion in 1975 to $3 billion in 1979. Moreover, the Health Insurance Association of America (HIAA) now estimates that the 1981 shortfall will exceed $4.8 billion. This gap will surely widen if Congress approves a 2% across-the-board reduction in Federal reimbursements to hospitals for Medicare patients.

Faced with this shortfall in revenue, hospitals have two choices. They may draw upon available hospital reserves, if any, to make up the deficit or they must overcharge patients who are not under government programs. Most hospitals adopt the second option to preserve their fiscal integrity. Thus, government reimbursement practices lead directly to differentials in payment between government and private patients. The end result of lower Medicare/ Medicaid payments is cost-shifting to private patients, not cost containment.

These growing shortfalls are hurting hospitals, hampering employer efforts to contain health care costs, and inhibiting the potential for further developing competition in the health care system.

Many inner-city and rural hospitals with a high proportion of Medicare/Medicaid-cost-reimbursement patients have extraordinary shortfalls and differentials. At these hospitals, there are fewer patients who pay full charges, and the hospitals are unable to shift their losses to private patients. Consequently, it is not surprising that some of these institutions are already in financial distress, and the 2% reduction could be the final blow. One hospital administrator expressed the dilemma to us this way:

"Today, at Greater Southeast Community Hospital (in Washington, D.C.), a patient who is hospitalized for five days and who undergoes surgery will incur the same charges or bills -- but the hospital will be paid the following: D.C. Medicaid, $2,401; commercial insurance, $3,184; Blue Cross, $2,881; Maryland Medicaid, $2,675; and Medicare, $2,520.

"That's a 25 percent spread on one bill. This inequity punishes hospitals and patients alike, particularly middle-class patients who must subsidize the below-cost reimbursement of Medicare and Medicaid." (Barry A. Passett, President of the Foundation which oversees Community Hospital in Washington, D.C.)

Arbitrary reductions in government reimbursements do not encourage hospitals to economize to meet lowered payment schedules. Instead, once hospitals begin shifting costs to the private sector, increasing charges becomes a logical and routine response to government reimbursement limitations.

Clearly, the severity of the problem restricts competition in the health care marketplace. Stated very simply, private payors cannot compete with Medicare (for example, through a voucher system) when the government buys at less than full cost 40 percent of the nation's total hospital services. Hospitals cannot compete on the basis of price when their payments are arbitrarily reduced for a large percentage of their patients. Furthermore, in certain areas of the country, commercial insurers are virtually unable to compete with Blue Cross plans because of Blue Cross contractual arrangements to pay hospitals less than they must charge other private patients. In those areas where the Federal shortfall is not spread evenly across the non-government patients, the problem is, of course, exacerbated.

Mr. Chairman, the designers of Medicare believed at the outset that by paying only for the actual cost of treating government-program patients (i.e., the "cost payment" method), hospital reimbursement would be effectively controlled. It soon became apparent that the cost-payment method, which provided for retrospective payment of all recognized costs, did not result in the desired accountability.

On the contrary, because the costs were adjusted by being paid retrospectively, hospitals were not at risk financially and, therefore, had little incentive to hold down costs. What reward did a hospital administrator get who worked hard and did, in fact, lower his costs? Less money. A reduced cash flow. Is it any wonder that Medicare/Medicaid expenditures began to outstrip general inflation in the economy?

What of solutions? The Congress made a beginning last year when it directed the Department of Health and Human Services, in Public Law 97-35, to devise a system of prospective reimbursement for hospitals suitable for both Medicare and Medicaid. We strongly support the development of a prospective reimbursement system that is equitable to all payors and provides hospitals with rewards, not penalties, for more efficient behavior.

Other steps toward a solution have already been taken in a few states. Examples are Maryland, New Jersey, and Illinois. Enabling legislation in these states gives hospital rate-setting authorities jurisdiction over rates paid by all private sector patients.

In addition, these authorities have obtained approval from the Federal and state governments to establish comparable rates for Medicare/Medicaid payments. Such approval was obtained under Section 222 of the Social Security Amendments of 1972. This section allows the Secretary to waive the usual reimbursement regulations in order to experiment with prospective payment systems.

By participating in the waiver system, Medicare and Medicaid agree to reimburse for certain services for which they would not otherwise pay. In effect, therefore, they would pay on the same basis as private insurers.

On the surface, such concessions would appear to be more costly. Medicare and Medicaid, however, are willing to participate in prospective payment systems under the waiver authority because these systems provide positive incentives for reducing overall hospital cost escalation and thereby generate cost savings.

These incentives result because this system prospectively approves a hospital's budget, thereby determining in advance needed hospital revenues which will form the basis of payment by all patients.

In this way, hospitals are encouraged to achieve savings by increasing their operating efficiency. By reducing operating below approved revenue levels, a hospital can produce a surplus that can be used at its discretion. It can be applied to new programs, services, or simply contributed to the hospital's reserves to help assure financial stability.

It should be pointed out that a waiver includes inside limits on the government's liability. Operating with a Medicare/Medicaid waiver, Maryland has achieved both equity among payors and government payments that are at least as low as they would have been in the absence of the program.

In the three years of 1978, 1979, and 1980, the Medicare and Medicaid program saved a total of $86.5 million in Maryland compared to what total expenditures would have been if that state's program did not exist.

Mr. Chairman, the HIAA is completely supportive of the Administration's goal of controlling inflation. No industry is hurt more by inflation than the insurance industry. Our support for cost containment measures in the health field has been second to none. Most recently, in January of this year, the HIAA joined five other national organizations, including the AFL-CIO, the Business Roundtable, Blue Cross-Blue Shield, the American Hospital Association, and the American Medical Association, in a joint statement calling for the development of health care coalitions on the state and local level as an important means of restraining costs and improving the quality and access to care. However, it must be clear from the foregoing that the HIAA must oppose the 2% across-the-board reduction in Federal reimbursements to hospitals for the care of Medicare patients, as well as any other arbitrary cuts in payments to providers which do not in reality represent true program cost reductions but are merely the shifting of present costs to other patients.

The 2% solution shows in stark reality what has been going on for years, a continuing ratcheting down of Medicare reimbursement using one excuse after another to re-define "reasonable cost." There has always been an excuse, a reason, but the result has always been the same -- another ratchet down.

If the cost of medical care is too high, it is too high for all of us. It is simply not fair for the government to solve its problem by fiat and leave the rest of us to pick up the pieces. It has a responsibility to look at the results of its actions on the rest of the system.

The "2% solution" is not being a "prudent purchaser." It is not picking and choosing from whom it will buy, shopping judiciously for price and quality. It is using naked economic power that comes from the hospital's dependence on government patients and the full power of government to arbitrarily reduce its expenses across the board, take it or leave it.

Nor is the proposal cost containment, as many would have us believe. It is a step toward cost escalation and has a direct impact on not only hospitals, but employers and private-paying patients, who ultimately must bear the burden of spiraling health care costs.

And, as a practical matter, the hospitals, if it is enacted, have no choice but to take it. To those hospitals which are prosperous, and have plenty of charge patients to shift the cost to, it may be an excellent solution, preferable to razzle-dazzle rule changes that increase administrative costs and red tape with the same result. But the 2% solution hits all hospitals across the board, efficient and inefficient alike, lean as well as fat. The result must, in fact, be inordinately hard on those hospitals with a high proportion of Medicare and Medicaid patients, or a large proportion of charity cases or bad debts.

There are, on the other hand, practical steps to reduce program costs which we do not oppose. We would support bringing all Federal employees under the Medicare system, since many qualify for it already.

We do not oppose making Medicare secondary to employee group insurance for workers over age 65, nor do we see any practical problems with delaying the initial eligibility date for Medicare beneficiaries.

There is a broad agreement that the status quo is unacceptable. Indeed, research reveals a high degree of public concern with the problem. Though there may be difficulties in implementing corrective action -- and even a lack of unanimity on the best option -- the future stability of the health care system demands that the problems caused by cost-shifting be recognized, addressed and resolved in the public interest.

Mr. Chairman, on the subject of containing the rising cost of Medicare, there is another issue of vital importance -- the Medicare competitive contracting proposal and the overall budget crisis facing the intermediaries and carriers.

You are undoubtedly aware that total Medicare payments to hospitals, doctors, and other providers will come close to $50 billion dollars in 1982. Medicare payouts have increased by more than 20 percent each year since FY '80 and threaten the entire Federal budget.

I mention this because private insurance companies not only have the responsibility for paying claims efficiently, but also must assure that claims on the Trust Funds are legitimate, appropriate, and reasonable. The intermediaries and carriers have performed this function on a no-profit, no-loss basis since this partnership for Medicare Administration was formed in 1966. This method of joint administration which costs only 1.7 percent of the whole program, has been a major success and serves as a model for how complex public programs can be managed.

In this context, the competitive contracting proposal sends us another signal that too many people are focusing on the 1.7 percent rather than on the $50 billion. In 1972 it cost 3.4 percent of the total program for administration. Today that figure has been cut in half. Our record for consistently lowering the cost of claims administration despite inflation and increasing workloads is clear.

However, the budgets for Medicare Contractors for FY 1981, 1982, and now proposed for 1983 are so seriously under-funded that they jeopardize the partnership built so carefully over 15 years. The tail is wagging the dog. Budget cuts have forced us to give up the trained professional personnel we need to adequately supervise the $50 billion in program payouts. If the Medicare carriers and intermediaries are to continue to do the job expected of them, they must be adequately funded. To do otherwise is penny wise and pound foolish on an unprecedented scale.

Thank you.

Statement of

The American Association of Homes for the Aging

before the

Committee on Finance

of the

United States Senate

Concerning

The Impact of the Administration's Proposed Budget Cuts

12 March 1982

The American Association of Homes for the Aging respectfully submits these comments to the Senate Committee on Finance concerning the impact of the administration's proposed budget on long term care. AAHA represents nearly 2,000 not-for-profit providers of long term care, housing, and housing-related services for the nation's elderly. Over 50 percent of our member skilled nursing facilities and intermediate care facilities participate in the Medicaid program, and many of our members also participate in the Medicare program.

The administration plans to reduce Medicaid expenditures $2 billion in FY 1983, and the Medicare program by $2.5 billion. The magnitude of these budget reductions will clearly and profoundly affect the ability of our member nursing homes to provide quality care to Medicaid residents. We see in these drastic cuts the continuation of process, begun last year, in which the service delivery system in long term care is being re-ordered to eventually mirror the almshouses that shocked the public consciousness at the turn of the century. Not since the Great Depression have public conditions threatened to abandon the poor, sick, aged and disadvantaged. We plead before this Committee for relief from these budget proposals which are morally and ethically repugnant.

Our position is predicated on the assumption that the government cannot reform the admittedly expensive public pay programs with a simple meat ax approach, without causing severe disruptions in the lives of thousands of nursing home residents in this country. The effects will not be hidden, nor will they be confined to the ledger sheets of recipient facilities. Rather, the impact will be seen in reduced admissions, reduced quality of life within the facilities, and reduced capacity to provide even the minimally acceptable (by today's standards) levels of care.

The cuts in nursing home financing are exacerbated by meat ax chopping of potential alternative programs in home care, social services and housing. The budget constitutes a statement of abandonment for the frail and vulnerable elderly.

For these reasons, we greatly appreciate the opportunity to speak out on the proposed cuts, and we applaud the scrutiny that these budget proposals are receiving in the Congress.

Medicaid

The proposed Medicaid reductions must be viewed in light of the $.9 billion reduction already built into FY 1983 by the Omnibus Reconciliation Act of 1981. The additional $2.2 billion cut would result in a $4 billion reduction over a mere two-year period (FY 1982-FY 1983), an astronomical sum when compared with the rising costs of and rising demand for Medicaid services. Reductions of this size cannot be achieved by simply rooting out waste and inefficiency, especially in an expedited time frame. Instead, the "savings" are obtained from the core of these program services, which still are considered vital to the provision of humane and quality care. The specific reduction proposals clearly bear this out.

The administration wants to reduce federal matching expenditures for the care of "medically needy" individuals by 3 percent for FY 1983. Persons in the "medically needy" category are characterized as "optional beneficiaries," with the implication that they are an insignificant part of the nursing home population. In fact, a substantial majority of skilled nursing and intermediate care Medicaid residents are within the "medically needy" category. These people have incomes too high to be eligible for mandatory assistance, but have also incurred major medical expenses. The administration's proposal, then, would slice an additional 3 percent from the federal contribution for the care of the category of indigent individuals which makes up the majority of Medicaid aged and disabled persons in nursing homes. Such a funding reduction would not merely affect "optional" beneficiaries in the normal understanding of the word, but would go to the heart of the nation's long term care population.

Similarly, the administration seeks a 3 percent reduction in the federal matching payments for the provision of "optional" services. Again, it is implied that "optional" services are frivolous, luxury items, but in fact they encompass such services as dental care, prescription drugs, and perhaps most importantly, intermediate care. Over the years, the provision of intermediate care services has become an integral part of the long term care system. At a time when public policy and common sense have mandated that greater emphasis be placed on providing the appropriate level of care for each individual in the long term care system, it is seemingly contradictory to hamstring a widely-used level of care which is proven effective and less costly than skilled nursing or acute care services. If intermediate care becomes financially prohibitive for facilities with resident populations (and potential populations) requiring twenty-four-hour-a-day care, and the availability of such care is drastically curtailed, then the alternative is placement at the skilled nursing level,or in hospitals because of the shortage of skilled nursing beds. This would not be in the best interests of the individual, who may receive care overly intensive in relation to his/her needs. It also is not in the best interests of the public funding agencies, since skilled nursing care is often significantly more costly than intermediate care and hospital costs are up to ten times as expensive.

In addition to the specific issues raised by the proposed 3 percent reductions, a more general concern must also be considered. A blanket percentage reduction does not permit recognition of the merits of a particular program, nor does it separate efficient from inefficient operations. Instead, it affects all long term care facilities, regardless of previously-implemented cost-cutting measures. A tremendous burden is placed on the states, where they will have to choose between curtailing needed programs and services or increasing their own spending to offset the federal reductions. Since many states are in serious financial circumstances, it is unfortunately clear how they will resolve that dilemma. Further, there is a strong possibility that states would move to maximize Medicare and therefore increase federal costs in that entitlement program.

In addition to the reductions of optional services and services to the medically needy, we are also concerned about the proposed combined welfare administration block grant, wherein Medicaid administrative costs would be placed within a block grant, along with the administrative costs for the Aid to Families with Dependent Children and food stamp programs. This block grant would be funded at 95 percent of the projected 1982 administrative expenditures in the areas. In addition to limiting the states' capacity for ferreting out fraud and waste, the block grant approach would also hamper their ability to assume the greater programmatic responsibilities envisioned for the states in the draft of the new Conditions of Participation and survey and certification rules presently under development within the Department of Health and Human Services. Further, we fear that, as an alternative, the states may recapture the necessary funds for administration by withholding an additional amount of financial assistance from the facilities. On top of the other proposed funding reductions, this indirect reduction could have a truly debilitating effect on the ability of nursing homes to provide quality care.

The proposal to "allow states flexibility to recover long term care costs from beneficiary estates and relatives" raises several questions which must be clarified by the administration. While the concept may be appropriate for discussion, it is not clear whether the administration is seeking to use family contributions as a supplement to Medicaid payments, or as a partial replacement for such payments. This may pose the unwelcome scenario where the states further reduce Medicaid payments, and put the burden on nursing homes to seek substitute funding from the beneficiaries' families. AAHA strongly opposes this use of family supplementation. The high costs incurred in locating families and soliciting payments, merely to regain the original levels of financial support, make this an extremely undesirable approach. Its primary effect would be to shift costs to the facilities, at the eventual expense of the residents, in terms of reduced funds available for programs and services.

Another cost-shifting effort is seen in the proposed mandatory co-payment for Medicaid services. The policy assumption behind this idea appears to be that too many people with medical needs seek medical attention at public expense. By giving Medicaid-eligible persons the responsibility of paying the first dollar for medical services, the administration hopes to decrease the incentive to utilize the available services. Thus, a dual cost-savings is achieved through a reduction of the actual federal-state Medicaid payment, and by an anticipated reduction in the use of services.

This proposal raises significant ethical questions. There is no division made between those persons who can afford the co-payment and those persons who cannot. It raises the spector of people actually being too poor to receive Medicaid benefits, as it does not account for an individual's inability to contribute towards his/her care. This, as much as any proposal in the administration's budget, illustrates how easily holes can be made in the social safety net. Reliance on the private sector to identify and subsidize people affected by the co-payment provision cannot be without limits. The budget reductions over the past two years have placed increasing strains on the community sources of funding of charitable activities. At the present time, it is difficult to be confident that such community support can sufficiently compensate for the future compounding deficits that appear likely to occur.

Medicare

The underlying theme in the budget presentation for Medicare is one of cost-shifting. The budget proposes a number of steps which shift costs to providers, consumers and to state governments. What is clear from a reading of the budget proposals is that the administration is more concerned with the short-range fiscal impact of the budget cuts than it is in the long-range consequences.

The cost-shifting through provider screens and integrated percentage cuts to providers will not bring systemic changes in health care delivery, but will lead to policies of cost avoidance. Less providers will serve the poor and disadvantaged and those that continue to do so will either become Medicare mills simply pushing people through, or bankrupt. For the individual, cost-sharing will increase his/her disposition of resources leading to eventual pauperization. Medicaid rolls will increase as new, eligible persons spend down to the level of catastrophic protection. States will suffer the pains of disregarding need or raising revenues to compensate for the failure of the federal structure to promote the public welfare.

For example, the proposed budget would eliminate the federal matching payments for the beneficiary share of Supplemental Medical Insurance premiums. This appears to be little more than the shifting of additional costs to the states, with the inevitable result that even more money will be drained from the state contribution to actual program services. This particular provision cannot be viewed in a vacuum, but must be seen in the context of the full array of proposed reductions in federal Medicaid contributions. With financial pressures being placed on the states from every aspect of the Medicaid program, the termination of federal matching payments for Medicare Part B premiums will only accelerate the return of the "warehousing" concept to the realm of policy acceptability. States, burdened by a reduced tax base due to tax reductions and the depressed economy, may be forced into the position of mirroring the federal government's meat ax approach to ward off fiscal instability. Despite denials made at various levels within the administration, this can only be done "on the backs" of the indigent elderly and disabled.

Also, the administration has been promoting the concept of maximizing free-market forces in the health care field, and has promised to submit a comprehensive "pro-competition" bill this year. While this bill would be timed for FY 1984, we feel it is appropriate to offer our views on the subject, due to the apparent reliance that will be placed on the pro-competition approach.

At the outset, we urge the rejection of any "market" proposal which signals a governmental decision to do so much for the elderly, but nothing beyond that point, leaving them to their own devices as part of a Darwin-type scheme. Competition should never become a code word for the dilution of the public sector's commitment to the elderly persons in this country.

As we understand it, the administration is contemplating some sort of voucher system, wherein a person could select the type of health care coverage that best suits his/her medical and economic needs. We must join the ranks of those who have voiced some concern over the ability of the at-risk populations, who are vulnerable because of age or multiple chronicities, to be informed consumers. While the theory behind the voucher has a certain appeal, it is doubtful that many of the indigent elderly and those persons with impaired mobility can make the sophisticated decisions that would be thrust upon them by this proposal. Efforts by the Department of Health and Human Services to educate the users of vouchers would have to be intensive and probably very expensive, without a clear probability of success.

We urge the Congress to avoid the simplistic categorization of the issue as being a matter of either pro-competition or pro-regulation. If we as a nation do move towards competition, it is inevitable that a final product will contain a blend of these concepts, and thus manifest free-market aspects to create incentives for cost reduction while preserving the government's historical stake in the process as a defender of the poor, infirm, elderly, and disadvantaged. Towards this goal, we commend the systematic review performed by this Committee during the 96th Congress of proposals to utilize the Medicare and Medicaid programs to provide catastrophic health care protection. Likewise, we think it would be useful to explore the use of the Internal Revenue Code to create incentives for the proliferation of privately-sponsored care. While we as an association do not endorse either of these options at this time, we do believe that they have the potential to free up significant resources, to be used in a more effective manner.

AKP/bjc
3-10-82

United Cerebral Palsy Associations, Inc.
Governmental Activities Office
Chester Arthur Building, Suite 141
425 I Street N.W.
Washington, D.C. 20001

(202) 842-1266

February 18, 1982

Honorable Robert J. Dole
Chairman
Senate Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Attention: Robert E. Lighthizer
Chief Counsel

Dear Senator Dole:

In response to your announcement of Committee hearings March 10-12 on Administration proposed budget reductions, please find enclosed our February, 1982 Word From Washington Analysis paper, "UCPA Affiliates Report Title XX Social Services and Maternal and Child Health Budget Reductions." Please feel free to use the paper in whatever way that would be of assistance to the Committee, including its reproduction in the hearings transcript.

If we can be of assistance, please let us know.

Sincerely,

E. Clarke Ross

E. Clarke Ross, D.P.A.
Director

ECR/rlk

Enclosure

LEONARD H. GOLDENSON CHAIRMAN OF THE BOARD
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Word from Washington

ANALYSIS

Volume Eleven Number Two

In Depth Resource Material
Prepared for Affiliates Of
United Cerebral Palsy Associations, Inc.

UCPA AFFILIATES REPORT TITLE XX SOCIAL SERVICES AND MATERNAL AND CHILD HEALTH BUDGET REDUCTIONS

This paper has been prepared at the
request of Representative John D. Dingell,
Chairman, House Committee on Energy and Commerce

by

E. Clarke Ross, D.P.A., Director and
Merna N. Williamson, Research Assistant
UCPA Governmental Activities Office

February, 1982

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DOCUMENT'S PURPOSE

This paper has been developed in response to a January 22, 1982 letter from Representative John D. Dingell (MI), Chairman, House Committee on Energy and Commerce. The Committee is gathering information "on the effects of the Reagan budget cuts on the programs under our jurisdiction" in preparation of the report they must file to the House Budget Committee.

In his letter to UCPA, Chairman Dingell stated that "I am writing to you because you and your associates were so helpful to the Committee last year when we were trying to understand the effects of each and every program cut and restructuring. During the next two weeks I hope you will be able to provide the Committee staff with updated information. What effect have the program and budget cuts had on services and people? What effect would further reductions have on programs and people? Are there any special cases, histories, or events that illustrate clearly how the budget cuts are being felt?"

THE F.Y. 1982-1983 FEDERAL BUDGET

In terms of the major federal programs of highest priority interest to UCPA, most of these programs were protected by the Congress in fiscal year 1982.

The Administration had proposed the block granting of P.L. 94-142, the "Education for All Handicapped Children Act," and had recommended funding reductions of roughly 30% from the 1981 level. By P.L. 97-35, the Budget Reconciliation Act, Congress extended P.L. 94-142 for several years as a categorical program. And by P.L. 97-92, the F.Y. 1982 Continuing Resolution, P.L. 94-142 appropriations were actually increased over 1981 for 1982. Of course the Administration has proposed a substantial rescission in these 1982 levels but Congress has not yet accepted this proposal.

Likewise, in P.L. 97-35 the Congress rejected the Administration's block grant proposals regarding state grant programs of Vocational Rehabilitation, Independent Living, and Developmental Disabilities. And P.L. 97-92 increased the 1982 VR funding level and held constant the IL and DD levels. Congress will have to once again reinforce these decisions as the Administration seeks 1982 rescissions.

The Administration also sought an arbitrary "cap" or ceiling on Medicaid expenditures in FY 1982. Again, the Congress through P.L. 97-35 retained the entitlement feature of Medicaid, rejected the cap proposal, and enacted higher state matching rates. Though matching rates were increased, because of the efforts of House Subcommittee on Health and the Environment Chairman Henry A. Waxman (CA) and Mr. Dingell, P.L. 97-35 also contained a new "waiver" provision program allowing noninstitutional community-based services under Medicaid at state option. As of this date, nine states have submitted waiver requests and two states have received application approval.

So five major programs of UCPA interest--P.L. 94-142 Education, $931 million; VR, $863 million; IL, $17.280 million; DD, $60 million; and Medicaid, $17.2 billion--were largely protected in FY 1982 (unless last minute rescission decisions are made).

However, two service areas of UCPA priority did not survive in as strong a condition. The Congress rejected the Administration's proposals to block grant both the Title XX Social Services and Maternal and Child Health services programs but major revisions were made in both programs. Regarding Title XX, state matching requirements were eliminated and the services, day care set aside, training, and administration functions were consolidated in what is now referred to as the Social Services mini-block grant. Likewise, seven previous categorical programs, including Crippled Children's Services, Genetic Diseases Program, and SSI Disabled Children's Program were consolidated into a new MCH block grant program. So the immediate focus of UCPA budget reduction concern in the human services areas (keeping income assistance and research areas separate) is with Title XX and MCH. The financial condition of these two programs follow:

Program	FY 1981	FY 1982	President's Proposed FY 1983 Budget
Title XX Social Services	$2.9 billion	$2.4 billion	$1.974 billion
Maternal and Child Health Block Grant	$447.6 million	$347.5 million	$1.000 billion
a) Women, Infant, and Children (WIC) nutrition program	$927 million	$934.1 million	0 to be consolidated with MCH
b) MCH-WIC totals	$1.375 billion	$1.282 billion	$1.000 billion

UCPA AFFILIATE APPROACH

In fiscal year 1980, UCPA's 250 affiliates had a combined operating income of $109.758 million, of which $70.457 million was derived from state and local government grants and contracts. UCPA does not operate a centralized and computerized affiliate data gathering system so financial records are frequently outdated. Records of the UCPA Washington office documented 62 affiliates receiving Title XX, CCS, or MCH funding. In response to Representative Dingell's request, a telephone survey of these 62 affiliates was developed by Merna Williamson, Research Assistant, UCPA Governmental Activities Office.

Of the 62 affiliates, 3 no longer operate any of these three funded programs and one affiliate was unreachable despite several attempts. In two other affiliates, the executive directors were not available and no one else in the affiliate could provide the necessary information. Thus this report includes 56 affiliates and 59 funded programs as several affiliates operate programs funded by more than one of these three programs.

TITLE XX AND MCH BUDGET IMPACT

Ms. Williamson's telephone survey revealed the following results:

- Twenty affiliate programs (34% of the survey) experienced program reductions; of these, 18 were Title XX reductions, 1 was CCS, and 1 was MCH.
- These 20 programs experienced Title XX, MCH, and CCS dollar reductions of at least $658,131. Roughly $127,000 of these reductions have been replaced with other public and private funding.
- Thirty-nine affiliate programs (66% of the survey), including 34 Title XX programs and 5 CCS programs have experienced no program reductions. However, many of these affiliates are expecting reductions by the end of their state's fiscal year and few of these affiliates are able to serve the needs of persons with disabilities as they would like even with present funding. Though programs have not received actual dollar reductions, because of inflation there have been real dollar reductions.
- Program reductions range from 2% in Pittsburgh in their Handicapped Adult Recreation and Social Program and in Utah in their Handicapped Summer Camping Program to 50% in Cedar Rapids where, as a result, their Handicapped Adult Day Care Program was terminated. Lexington, KY UCPA also experienced a 50% cutback which has resulted in severe curtailment of their training of parents and paraprofessionals in the care of their handicapped children.
- In Columbus, OH, as a result of a $180,000 Title XX program reduction in their Handicapped Adult Services Program, 110 disabled adults have been terminated from service. These adults now are isolated in their residential setting with absolutely no daily or special day services.
- In Erie, Pennsylvania, as a result of a Title XX cut, the UCP Adult Day Care Program serving 36 persons with disabilities was closed.
- In Illinois, work by the Human Services Override Coalition, of which UCP of Illinois is an active member, convinced the Governor's office to restore $2.4 million in Title XX program reductions. In April 1981, Governor Thompson proposed a four year program, involving 25% annual cuts, to phase-out all Title XX contracts involving donated funds. These programs will now stay operational at least through FY 1983.
- In Maine, the state's administration has declared their intent not to reduce current human services in spite of substantial reductions.
- In San Antonio, TX, where UCPA has been able to document cost differentials of $2,400 per month institutional costs and $500 per month community placement costs, UCPA's independent living program will receive a Title XX increase.

- For the 20 affiliate programs being reduced, most are reducing administrative costs, attempting new private fund raising initiatives which have not yet been successful, and increasing staff-client ratios while reducing the level of client services.

OTHER BUDGET OBSERVATIONS

- Though the Developmental Disabilities federal budget has technically only received a 4% reduction, as specified in P.L. 97-92, state DD programs are being terminated. For example, in Pennsylvania, the DD council funded in FY 1981 13 DD-CLA (Developmental Disabilities-Community Living Arrangements) programs. In FY 1982 only 3 of these independent living programs are operating and they will be terminated at the end of this fiscal year. The DD Council's expectation that these 13 programs would be permanently financed by the state was dissolved when Pennsylvania received word of the P.L. 97-35 federal reductions. Some of these program participants are now being reinstitutionalized.

- Many affiliates reported substantial reductions in CETA (Comprehensive Employment and Training Act) personnel though this was not an area of survey questioning.

SURVEY RESULTS

Specific program information listed by affiliate follows:

TELEPHONE SURVEY OF AFFILIATES RECEIVING TITLE XX, CCS OR MCH FUNDS

by Merna Williamson--February 17, 1982

STATE/AFFILIATE	Pro-gram	Cutbacks		Cut Amount	Cut Date	Services Affected	% of Budget		Cutbacks Have Been Restored by Funding Sources
		Yes	No				Before	After	
ALABAMA									
Gadsden	XX		X						
Huntsville	CCS		X						
Sheffield	CCS		X						
Birmingham	CCS		X						
"	XX	X					45%		MH Dept. made up cut
Anniston	CCS	X		$3,000		Crippled Children's	9%	6%	No
"	XX		X						
ARIZONA									
Phoenix	XX	X		$26,000		Transp., DD Therapy, Group-Home Training, All services. This prgm cut 25%	22%	16%	Some state funds
CALIFORNIA									
San Diego	XX		X						
CONNECTICUT									
Hartford	XX		X						
FLORIDA (big cuts expected)									
Orlando	XX		X				5%		
Panama City	XX		X						
Lakeland	XX		X				75%		
Miami	XX		X				75%		
Ft. Lauderdale	XX		X				30%		
Tallahassee	XX		X	--7¼% increase--					
GEORGIA									
Rome	XX	X					25%	25%	No
Macon	XX	X		$500	1/1/82	Day care for disabled infants, children & adults.	25%	25%	No,Cut services
ILLINOIS									
Decatur	XX	X			7/1/81	Family support-Advocacy	40%		All funds restored
Joliet	XX	X			"	" " "			" " "
Chicago	XX		X	--25% cuts proposed, never enacted--			5%		" " "

STATE/AFFILIATE	Program	Cutbacks		Cut Amount	Cut Date	Services Affected	% of Budget		Restoration
		Yes	No				Before	After	
IOWA									
Cedar Rapids	XX	X		$50,000	7/1/81	Disabled Adult Day Care	50%	0	No--working on it.
KANSAS									
Wichita	XX		X						
KENTUCKY									
Louisville	MCH	X		$27,000	7/1/81	Early childhood intervention--Infant development	14%	8½%	Special local grants
Lexington	XX	X		$100,000	7/1/81	Paraprofession & parent training to care for handicapped children	100%	50%	Local grants & endowments
MAINE									
Augusta	XX		X				10%		
Bangor	XX		X				20%		
"	CCS		X						
MARYLAND									
Baltimore	XX		X						
MINNESOTA									
Minneapolis	XX		X				8%		
MISSOURI									
St. Joseph	XX		X						
NEW YORK									
New York State (NY City)	XX		X				Small%		
Albany	XX		X				"		
Geneva	CCS		X			Pre-school	100%		
Niagara Falls	XX		X			Handicapped Adult Day			
Jamaica	XX		X						
Utica	XX		X						
Purchase	XX		X						
Buffalo	XX		X						

STATE/AFFILIATE	Pro-gram	Cutbacks		Cut Amount	Cut Date	Services Affected	% of Budget		Restoration
		Yes	No				Before	After	
NORTH CAROLINA									
Raleigh	XX	X		$30,000	7/1/81	Day Care	27%	23%	No
OHIO									
Columbus	XX	X		$180,000	2/81 10/81	Handicapped Adult Service Center	100%	100%	Cut services No
Akron	XX	X		$100,000	7/1/81	Cut Administration and Service Level	25%	20%	No--have applied for 10 grants
Cleveland	XX		X						
Cincinnati	XX	X		$92,000	7/1/81	Adult Work Activity	25%	13%	Yes--Community Serv.
Dayton	XX		X			Adult Day Care	33%		
OREGON Portland	XX		X						
PENNSYLVANIA									
Lewiston	XX		X			Handicapped Counsel.	25%		
Lancaster	XX	X		$ 9,000	7/1/81	Adult DD program	25%	13%	No--cut staff
Scranton	XX		X			Adult Activities	75%		
Erie	XX	X				Adult Day Care			No
Pittsburgh	XX	X		$13,631	7/1/81	Social Activities & Recreation for Severely disabled adults.	15%	13%	No
Pottsville	XX		X			Activities for adults	--Small--		
Johnstown	XX	X			7/1/81	DD Day Care (58 children).	50%	30%	No. Now a fee-for-service program and only able to open 4 days per week instead of the previous 5.
SOUTH DAKOTA Sioux Falls	XX		X				4%		
TEXAS									
San Antonio	XX		X						
Dallas	XX		X			Adult Day Care	16%		
Austin	XX		X			Adult programs	50%		
UTAH Salt Lake City	XX	X		$14,000	7/1/81	Summer Camp for Handicapped Chdrn.	22%	20%	No--prgms already cut 40% before
WASHINGTON Tacoma	XX	X		$13,000	7/1/81	Workshop, DD Activ.	33%	18%	No

CONCLUSION

Service programs for persons with disabilities, if UCPA is characteristic of the disability field, have frequently been protected by many federal, state, and local government legislative and executive agencies in comparison to other human services constituencies. The most vulnerable programs serving the disabled appear to be day community programs for both adults and children funded through Title XX Social Services contracts.

This survey did not include the loss of personnel assisted by the CETA program. CETA programs were reduced from $7.143 billion in FY 1981 to $3.003 billion in FY 1982. The President has proposed a further reduction in FY 1983 to $2.387 billion and CETA'S replacement with a new employment and training assistance block grant to the states. UCPA affiliates with CETA contracts are encouraged to document their experiences with the UCPA Washington office.

In a paper prepared for the UCPA governmental activities committee ("Congregate Housing Services Program: A Review of P.L. 95-557," February 1982), UCPA Professional Services Program Department Consultants Rachel Warren and George Gray documented several nonprofit organization recipients of HUD Section 202 housing construction loans who were postponing development because of the lack of available services financing. This could be the beginning of a slowdown or termination to deinstitutionalization efforts in several states.

UCPA affiliates are strongly encouraged to send their government grant and contract experiences to the UCPA Washington office. Only by accurate and complete documentation can we demonstrate to federal policy makers and analysts the real impact of federal budget reductions.

Word from Washington

E. Clarke Ross, D.P.A.
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Missouri Child Support Enforcement Assoc.
c/o Support Enforcement Unit
Office of Prosecuting Attorney
Buchanan County
St. Joseph, Missouri 64501

Patricia Eddins
President
(816) 271-1492

March 16, 1982

To: Senator Robert Dole, Chairman, and
Members of the Senate Finance Committee

From: Missouri Child Support Enforcement Association
Patricia Eddins, President

Subject: Child Support Enforcement Program
Alternative Funding Proposal

The Missouri Child Support Enforcement Association appreciates this opportunity to express our concerns and recommendations concerning the Administration's proposed budget cuts and alternative funding proposals for fisical years 1982 and 1983, regarding the Child Support Enforcement program.

ALTERNATIVE FUNDING PROPOSAL

The Federal government (HHS), Office of Child Support Enforcement, is attempting to implement, effective July 1, 1982, a "formula" that would totally restructure the program's funding mechanism. It will eliminate the present funding rate of 75% for state and local administrative costs and the 15% incentive for AFDC collections. The new formula requires states to fund their entire program expenditures (both AFDC and Non-AFDC) from their AFDC collections. Incentive payments are to be paid based on increased AFDC collections and improved cost effectiveness.

The Administration's budget package projects a savings of $35 million for 1982 and $157 million for 1983. Out of these savings, $25 million is expected from actual expenditure reductions for 1982 and $100 million for 1983, due to the implementation of the new formula. It is being presented as a means to increase cost effectiveness and efficiency in States' programs, but was actually developed from the ground up to meet a predetermined budget cut.

As of this writing, we are still waiting for the official formula and the supportive data which reflects how the formula will effect each state. So far, only unofficial versions of the formula have been released by the Administration.

PROBLEMS AND EFFECTS OF THE FORMULA

1). Increased AFDC expenditures; elimination of the Non-AFDC program.

As stated previously, states will be required to fund their entire program costs out of their AFDC collections. States will still be responsible to maintain a Non-AFDC program, but there will be no positive funding for this portion of the program.

Recent budget cuts have taken thousands off the AFDC rolls. These people now, more than ever, are relying on the Non-AFDC program to assist them in obtaining their child support. Because of the inevitable demise of the Non-AFDC program, their last hopes are being quashed.

Last year, $870 million was collected nationally for Non-AFDC children. These collections produce a direct cost avoidance factor.

Because of the reduced enforcement, Non-AFDC collections will drastically decrease, the children will be deprived of support monies, and their parents will be forced to turn to the government for assistance. If they are ineligible for assistance, and they are unable to afford private counsel, then there is nowhere else for them to turn.

This in turn means that absent parents have successfully been allowed to shirk their parental and financial responsibility; a fact that is contrary to one of the program's main goals and a fact that is also contrary to the present Administration's beliefs.

2). Minimize cooperation between states on interstate cases.

The new funding structure provides no incentive for interstate cooperation. This lack of incentive will necessitate local jurisdictions to adjust their entire program emphasis to their own local AFDC caseloads. Past strides toward interstate reciprocity will be stymied producing an elimination of interstate collections.

A move across state lines will once again allow the shirking of parental financial responsibility and the children will suffer from this allowed deprivation of support.

3. Reduced Establishment of Paternity.

Seventeen percent (17%) of the present births in this country are out-of-wedlock. In the past fiscal year, approximately 150,000 paternities were established. Reductions in funding will curtail this important accomplishment of the program because these cases are costly to handle. America's children born out-of-wedlock will be denied their identity and legal rights.

4. Incapability of states and local political subdivisions to appropriate additional funding.

Missouri, like many states, has a fiscal year which runs from July 1 to June 30. FY 1983 funding allocations are presently before the state legislature and the funding levels have already been determined. In order to implement the new formula, appropriation changes will be necessary and that requires legislative approval. There is little time left to make these changes.

The local governments in Missouri, and in other states, have an even greater problem. Their fiscal periods run with the calendar year and there is absolutely no flexibility to change this year's appropriation. This makes it impossible for the political subdivision to make adjustments which will be necessary to meet the formula implementation deadline of July 1, 1982.

In Missouri, there are approximately 650 people employed with the Child Support Enforcement Program. 205 Workers are employed by the State and the remaining 445 are employed by the 115 political subdivisions. The inability to appropriate additional funding will necessitate drastic reductions in staffing. As a result, strong enforcement activities will diminish and collections will plunge downward.

Also, not only are additional funding appropriations virtually impossible to acquire; but the formula is also burdensome to administrate and financially unreliable. Local jurisdictions will have to become experts in collection and expenditure forecasting and will be expected to accurately predict economic conditions such as in unemployment rates and inflationary factors which affect collections and expenditures. This extremely difficult task, along with the other problems caused by this new formula, will force many localities to withdraw from the program. In turn, major gaps in the enforcement network will develop and escape havens will again be established.

RECOMMENDATIONS AND CONCLUSION

Missouri, along with other states, recognize that we have a responsibility to the taxpayer to operate an efficient and cost-effective program. In the past five years, we have all been working very hard to attain this goal.

No other program has so drastically removed the financial burden from the taxpayers and returned the responsibility of supporting America's children to their parents.

In the past eighteen months, many states have passed legislation which should produce increased collections. Missouri has legislation pending which, if passed, is expected to increase our FY 83 collections by $8.8 million over Fy 82. Numerous states have passed tax intercept and wage assignment laws. Additionally, the Federal tax intercept law is in its infancy and has not yet been evaluated. This surge of legislative activity needs time to work.

Time is needed to find a more realistic means of redirecting cost responsibility.

The program must be strengthened rather than weakened. The foundation which has been laid over the past several years should not be allowed to erode.

We believe America's children are worth the investment and they should not be victimized by this hastily concocted attempt to reduce the federal expenditure.

We recommend that Congress be sensitive to the above problems and effects. Pro-child support enforcement legislation is needed. The growing momentum behind the program should be recognized and endorsed.

One goal of the present Administration is to reduce the federal budget and we feel that the Child Support Enforcement program DOES run concurrent with this goal. The proposed funding formula must be discarded so that the children and local taypayers of this country remain the beneficiaries of this program.

The Missouri Child Support Enforcement Association is grateful for this opportunity to express our concerns and beliefs.

STATEMENT OF THE
NATIONAL ASSOCIATION OF PRIVATE PSYCHIATRIC HOSPITALS
TO THE
SENATE FINANCE COMMITTEE
ON
FISCAL YEAR 1983 BUDGET
PROPOSED MEDICARE BUDGET REDUCTIONS

MARCH 1982

Mr. Chairman:

The National Association of Private Psychiatric Hospitals appreciates the opportunity to react to the fiscal 1983 Medicare budget cuts proposed by the Administration. We have serious reservations about unilateral actions taken without the benefit of a long term approach to restructuring a total system. We feel many of the proposed reductions are short term in nature and will do nothing to control costs over the long haul.

At the outset we must state that we are unalterably opposed to the 2% reduction in Medicare hospital reimbursement. It would cut payments to hospitals across the board, disregarding their efficiency, costs, case mix, intensity, or occupancy. We oppose cuts which are arbitrary, inequitable, and do nothing to resolve the real problems facing the Medicare program. Furthermore, such a cut would penalize those hospitals serving a higher proportion of Medicare beneficiaries. This seems totally punitive towards those hospitals committed to serving the Medicare population.

The National Association of Private Psychiatric Hospitals represents the nation's 203 freestanding (nongovernmental) psychiatric hospitals and related hospital-based psychiatric services. The hospitals, with over 24,000 beds, represent a variety of types of ownership and provide for the medical care and treatment of persons suffering from psychiatric disorders and impairments. The membership offers the wide and varied range of competitive hospital-based programs critical to addressing the needs of children, adolescents, adults, the elderly, the alcoholic, and the substance abuser. All of our member hospitals are accredited by the Joint Commission on Accreditation of Hospitals, the national agency for voluntary accreditation of hospitals.

We would like to take this opportunity to comment on some of the proposals mentioned in the administration's budget recommendations, as well as comment on some proposals not yet introduced but under active consideration by the administration.

Specific Proposals:

Repeal Waiver of Provider Liability

This provision would repeal a prior amendment passed by Congress to protect both institutions and beneficiaries from a retrospective denial of reimbursement for services. We believe this provision would unjustifiably penalize institutional providers which have delivered care deemed medically necessary and appropriate on the orders of physicians and other health professionals. Since physicians, not hospitals, order such services, such a repeal under Part A would be unfair.

Elimination of Utilization Review Requirement/HCFA/Private Sector Utilization Review Initiative

While agreeing in concept to the elimination of burdensome regulatory activities for hospitals, we are concerned that this proposal, established to save in excess of $300 million, has not yet been fully developed or articulated. We would and do strongly object to returning to a system which would vest the intermediary and third party payor with the responsibilities of reviewing care or determining the criteria under which care is deemed medically necessary or appropriate. Such a system would revive the arbitrary and capricious retrospective denials of care, which the psychiatric hospital is all too familiar with.

This association has endorsed the elimination of the PSRO program and is committed to developing a system which will remain institution specific in allowing the individual hospital utilization review committees to develop norms for admissions, lengths of stay, discharge criteria, et. al. Such a system would allow each institution to develop norms applicable to its setting, treatment goals, treatment objectives, and unique capabilities. Any system developed only with the payor's interest in mind would be unfair and in the long run more costly to a system, only encouraging inappropriate utilization or under utilization.

Medicare Contractor Initiative

This proposal would eliminate the providers'ability to nominate their own intermediary. Presently, the Secretary is required to assign intermediaries based on published standards and criteria for efficient administration. The proposed amendment would remove such a requirement. We feel such a proposal would be a detriment to the system.

Other Proposals:

Expanding Section 223 Limitations

While this proposal has not been formally introduced as part of the FY 83 budget, the Department continues to give active consideration to lowering Section 223 limits and expanding them to ancillary services. The specialty psychiatric hospital has long had difficulty in being reimbursed for what has been considered routine for their programs. The true cost of providing medically neccessary psychiatric care must include therapeutic services, i.e. education, social services, and therapeutic modalities. Such services are required of specialty hospitals under the Conditions of Participation for the Medicare program. However, they are rarely reimbursed. A further tampering with the 223 limitations would seriously limit the specialty hospital's ability to be adequately reimbursed and most likely would result in the hospital's inability to continue to adequately treat the Medicare population.

Propsective Reimbursement System

This Association stands ready to assist the committee and other interested parties as they explore alternatives to the present cost based, retrospective reimbursement system.

Such a system, however, must not penalize hospitals and must allow for such factors as intensity, case mix, efficiency, labor costs, debt financing, inflation, and demand.

The Association believes that the health care system has moved in the direction of greater competition and encourages this movement. While increased competition in the health care system may slow down escalating costs, any "procompetitive" approach should be implemented with thoughtful regulation in order to assure that consumers have adequate information about competing health plans and to protect unsuspecting consumers from plans which exclude necessary services.

Competition among health plans must be based on differences in deductibles, co-payments, catastrophic stop-loss contributions, and supplemental services. In addition, a basic package of minimum benefits must be maintained for all qualified competition health plans. Such a package should include all medically necessary physician and hospital services with no distinctions made between any medical specialties.

In conclusion, we believe a framework is crucial to assure adequate and continued reimbursement for all appropriate costs attributable to the Medicare program designed with incentives for the long term solvency of the program, minimizing cost shifting, assuring a catastrophic element not now found within the program, beneficiary cost sharing, and allowing for adequate planning to meet increasing demands.

Mr. Chairman, we thank you and the committee for giving us the opportunity to comment and we look forward to working with you as you consider the above proposals.

STATEMENT
OF THE
NATIONAL COUNCIL OF HEALTH CENTERS
TO THE
SENATE FINANCE COMMITTEE
ON THE
ADMINISTRATION'S PROPOSED FY 83 HEALTH BUDGET
SUBMITTED FOR THE RECORD

March 12, 1982

The National Council of Health Centers is pleased to have this opportunity to express our views on President Reagan's proposed budget for fiscal year 1983. Our comments will address those areas that directly or indirectly affect nursing homes as well as elderly Medicare and Medicaid beneficiaries.

The National Council of Health Centers is the national association representing multifacility nursing home firms with more than 170,000 nursing home beds in 49 states and the District of Columbia. Our members also provide a number of other health-related services including home health, adult day care, drug and alcohol rehabilitation, and retirement communities.

During the debate last year over the Administration's fiscal year 1982 budget, the National Council publicly supported the goals of the Administration's economic recovery program. In a telegram to President Reagan we stated, "We strongly endorse your proposal to shift the burden of health care delivery back to the free market place and support the inclusion of long term care services in that proposal. By allowing competitive forces to control costs and by easing the present tremendous regulatory burden, you will provide us with the new beginning that we so desperately need."

Today, one year later, we still firmly believe that a major reorientation of the health care system is in order with a shift in focus to private sector initiatives and the principles of competition through a prospective payment system.

We have come to rely too heavily on government for all the answers to our health care needs, at the same time expecting that it will pay for all these needs. As a result, programs have grown without the benefit of a cohesive long range policy or objective and expenditures have risen out of all proportion to that originally anticipated.

A more rational and logical approach is to define in advance government's role, the basic package of benefits which will be supplied, the population to be served, and the payment which will be made for those benefits. While this may sound simplistic, it is illustrative of the root of our problem: expectations with regard to coverage and benefits are unrealistically high and only lead to frustration when, for example, a Medicare beneficiary finds that only 38% of his medical costs are covered. The name given to these programs--"entitlement" is indicative of the general attitude that one is entitled to coverage of all his needs, yet given our economy's current condition the government clearly cannot afford that type of open ended liability.

At the same time, providers are caught by an inefficient and uncertain reimbursement system with cost disallowances, non-covered costs, and the lack of incentives for efficient performance. The nature of the system has spawned regulations, oversight and endless paperwork for the purposes of monitoring and overseeing the inefficient system.

As providers very much involved in providing a wide range of long term services, we have begun to explore alternative sources of funding for long term care and the appropriate roles of federal and state governments and the private sector. Essential to this process is the development of a payment system for government programs which is designed to stimulate the utilization of the most cost effective and appropriate health care services by the recipient. If this new proposed prospective payment system can be based on the competitive principles of the private marketplace, then by its nature, it will constrain costs.

We are encouraged that the Administration is not content with continuing the old inefficient and costly Medicare methodology. As the members of the Committee know, Medicare's retrospective departmental cost based system only invites piecemeal cutting of benefits and tightening of cost limits each year as expenditures for health programs increase beyond any projections made. Many of these increases are inevitable as technology improves, as the number of elderly eligible for benefits grow and demand more services. The certainty of these factors force major new approaches and proposals. Unfortunately in awaiting the Administration's new proposals, we are once again faced with more cuts and losses of benefits. We can only hope that the Administration will move quickly and that Congress will act swiftly in enacting these new initiatives because clearly neither states, nor providers, nor beneficiaries can continue from year to year as they have been with the uncertainty which currently prevails.

With these comments as an overview we would like to address specific proposals contained in the FY 83 health budget.

MEDICARE PROPOSALS

Equalization of Rates for Hospital Based and Free Standing Skilled Nursing Facilities and Hospital Based and Free Standing Home Health Agencies.

We are very supportive of this proposal for the reason that it makes no sense to pay higher rates for the same services to Medicare SNF patients merely because they were delivered in a hospital setting. Last year the average Medicare rate in a free standing skilled nursing facility was $45.36, while for a hospital based SNF, the average was $93.92.

The great difference between these two rates is also reflective of the inefficiencies of the Medicare cost reimbursement system, a system we believe should receive the highest priority in reforming the Medicare program.

Elimination of Waiver of Liability

The passage by Congress of legislation in 1972 enacting waiver of liability provisions and presumed coverage were symptoms of the already evident problems with Medicare's retrospective cost reimbursement system. Providers--hospitals and nursing homes--had to make the determination of whether a patient was covered by Medicare and they were then at risk for that decision. If a clerk in an intermediary's office disagreed with that decision, the provider in effect was punished by being denied payment for that patient's care.

Realizing perhaps that this policy put providers in an unfair position, Congress enacted provisions for Presumed Coverage and Waiver of Liability in Public Law 92-603. Last year Congress repealed the Presumed Coverage Provision and now the Administration proposes to do the same for Waiver of Liability.

From the perspective of skilled nursing homes, unless a prospective payment system for Medicare is enacted swiftly, the elimination of Waiver of Liability will all but eliminate the Medicare SNF program as well. Providers will have no recourse for any mistakes or disagreements regarding retrospective determinations in coverage.

A 1979 report by the New York State Office of Health Systems Management points out that Medicare specifically allows for presumptive coverage of Medicare benefits on the basis of a physician's certification of SNF level of care need. While this certification does occur, it is not accepted as a final decision, nor do most physicians sufficiently understand the intricacies of eligibility to correctly inform their patients. As a result patients are frequently told by their physicians that they will be covered, and they are almost always disappointed. Unfortunately, explanatory pamphlets distributed by federal agencies do little to dispel these expectations.

A report compiled by a Medicare Task Force of the Minnesota Foundation for Health Care summarized the perceptions and misperceptions about the Medicare program held by concerned parties in that state. Physicians commonly believe that all their patients' skilled care is covered by Medicare for up to 100 days. Consumers expect that any nursing home care will be covered for 100 days. Unfortunately, both of these perceptions are far from the truth as only about three percent of the patients in nursing homes are covered by Medicare and the average length of stay is only 24 days.

Prospective reimbursement would do much toward resolving some of these problems, but not other problems such as the overly restrictive definition of skilled care or the hospital backlog.

Hospital Backlog

A significant problem exists in the so called "hospital backlog" of patients in hospitals awaiting nursing home beds. One need only look at the number of states reporting serious backlogs of hospital patients awaiting a Medicare or Medicaid nursing home bed to appreciate the magnitude of the problem. These states include, to name only a few, California, Washington, Georgia, Massachusetts, Connecticut, Michigan, Minnesota, New York, and the District of Columbia. Data from individual states is supported by further national data indicating that 250,000 administratively necessary hospital days were used in the first quarter of 1979; and that "backup patients" average ten percent of a hospital's occupancy. Little computation is needed to figure savings to be gained by substituting a $45 per day rate in a nursing home for a $300 daily rate in a hosptial. The cost to the Medicare and Medicaid programs for these administratively necessary days has been estimated at $1.5 billion.

There is little incentive for hospitals to discharge these patients who are at an inappropriate level of care, and since there is no copayment until the 60th day of hospitalization, there is no reason for the patient to want to be discharged.

Maintaining hospital occupancy can be a critical factor especially when occupancy rates nationally remain at 75%. An HHS Region 10 study noted the effect of low hospital occupancy levels by citing the policy in one state to penalize through lower reimbursement, hospitals with occupancy rates less than 85%. The report states "Where there is a deliberate penalty, there is certainly an economic incentive to maintain occupancy rates".

This disincentive to discharge has been one of the reasons for the hospital backlog nor do we see the situation improving as reimbursement limits are tightened further and if utilization review is eliminated. If both PSRO and UR are abolished there will be no mechanism for identifying these patients and for assuring that they get transferred to a less costly and more appropriate level of care.

Three-Day Stay

One way of saving Medicare and Medicaid dollars is to assure not only that hospital patients are discharged in a timely manner, but also that they never enter a hospital unnecessarily. That is precisely what S.1507, the elimination of three day prior hospitalization would accomplish.

Last year Congress eliminated this requirement for home health services. S.1754 introduced by Senator Heinz last September would do the same for skilled nursing facilities.

As early as 1976 an HHS report, Forward Plan for Health, endorsed elimination of the three-day stay stating, " . . . experience suggests that significant numbers of Medicare beneficiaries now receiving hospital care would benefit as much from SNF care . . ." and " . . . it is probable that patients in need of only skilled nursing care, and who are now instead hospitalized are never subsequently transferred to an SNF because of paperwork (eg, transfer of medical records, treatment plan) and the lack of any financial incentive or disincentives (eg, no cost sharing is required after first hospital day and until the 61st day)."

In discussing potential savings, the Forward Plan for Health goes on to say, "since the average Medicare cost of a covered day in an SNF is less than one-third the routine cost per day in a hospital, the potential cost savings is obvious".

Much has happened in the intervening six years since HEW made that recommendation. Most notable is that hospital costs have now escalated to $200 to $400 per day. While the average Medicare SNF rate was $45.36 last year. It goes without saying that keeping any patients out of hospitals who don't need to be there would save millions of dollars.

Physicians freely admit that they place their patients in hospitals solely to qualify them for the Medicare SNF benefit. Many of these patients never find their way to the nursing home because a bed might not be available, or because they help a sagging hospital utilization rate and are never discharged into the appropriate level of care.

A four-year demonstration project in Massachusetts and Oregon which permitted direct entry into a nursing home of Medicare-eligible skilled nursing patients found cost savings in avoided hospitalization and identified a number of other potential indirect cost savings. These included fewer physician visits (physicians are reimbursed at a higher rate for their hospital patients versus nursing home patients) and lower ancillary services cost and utilization.

In evaluating the study results Abt Associates found a net potential savings of $3 million in eliminating the three-day stay requirement--an increase in Medicare SNF costs of $46 million and a savings of $49 million in reduced hospitalization. It should be noted that this evaluation was extremely conservative in deriving estimates and this was so stated in the report. Further, none of the potential indirect savings mentioned above were included, nor was there any consideration of those patients who enter hospitals in order to qualify, but who never are discharged, staying in the hospital until the termination of their illness.

The Abt study found that many patients who entered the nursing home directly under the waiver, were terminal cancer patients, those for whom heroic and costly life saving treatments are unnecessary. Other patients were at an intermediate care level and became more ill, making them eligible for Medicare. These patients would routinely have entered the hospital in order to qualify.

We should point out that the Health Care Financing Administration has refused to accept the results of the Abt study and discounts any potential savings because, according to HCFA, an empty hospital bed would be paid for anyway under Medicare's cost reimbursement system.

In our opinion, this only serves to point out the ludicrous nature of Medicare's reimbursement system, not the validity of the study's results. To imply that a hospital bed would be paid for by Medicare whether it is empty or not would seem to indicate a casual attitude towards restraining medical care costs that is certainly contrary to the expressed concerns of the President and the Secretary. We do not believe this is the case.

To those who have expressed concern over the potential for increased SNF utilization, we would propose the imposition of a high deductible, such as 50% of the hospital deductible to act as a barrier to unnecessary utilization. This amount would actually cover the cost to Medicare of the first three days in the SNF.

Prospective Reimbursement

Much of the dissatisfaction nursing homes have with the Medicare program can be traced to its retrospective system of reimbursement.

The complexity of retrospective reimbursement and its cost reporting requirements has forced nursing homes to hire CPA's with Medicare experience just in order to remain in the program. It is also the reason that many smaller homes and single facilities have been dropping out. When so few patients meet the Medicare eligibility requirements and then for only a few days' time, it is simply not worth the extra effort involved to maintain Medicare certification.

The case against Medicare's retrospective reimbursement is almost overwhelming. It is cost inflationary, provides no incentives for efficiency, nor for containing costs. Perversly, it rewards the inefficient provider: those who spend more, get more. At the same time, costs accepted as legitimate business expenses in all other sectors of our economy are not recognized by Medicare. Further its system of allocating portions of costs to various cost reporting centers is inappropriate and unnecessarily complex in the context of a nursing home.

In discussing the disadvantages of retrospective reimbursement, a study by the Battelle Institute notes, "The more complicated the system, the more likely the system will be unenforceable. Every additional cost item reviewed, audited, or monitored represents a further dilution of monitoring resources, and each additional regulation requires additional effort to assure compliance by the industry". This description fits the Medicare payment system perfectly. The Battelle study futher states, "Rather than trying to monitor and control the behavior of 18,000 individual nursing homes, attention should be directed to the design of a payment system for nursing home services in which incentives for the efficient use of resources are built into the system. There would then be no need for expensive if not impossible monitoring and control of the nursing home industry".

We endorse this recommendation wholeheartedly and believe that a prospective payment system fulfills these requirements perfectly.

The fact that 38 states already reimburse prospectively for Medicaid nursing home services should be a strong incentive for doing the same for Medicare. It is both illogical and inefficient to have two separate payment methodologies in effect in a 100 or 150 bed nursing home. Medicare's disallowances, non-covered costs, ceilings, and retroactive denials are disincentives which have nevertheless failed to restrain costs.

Various proposals for prospective reimbursement are being discussed and we welcome the dialogue. Many of the problems of Medicare--paperwork, complexity, inflationary aspects, could be eliminated simply by implementing prospective reimbursement. We are encouraged that the Administration and members of Congress are now giving this issue important consideration. We stand ready to assist in that effort.

MEDICAID

Three Percent Reduction in Match

For the majority of nursing home patients, Medicaid is the principle source of payment for their benefits. While we understand that many of the Administration's proposals are not cuts but rather reductions in the rate of spending, we wish to point out that with regard to the 3% reductions this is not necessarily the case. No matter how much states may have reduced their Medicaid expenditures, these proposals penalize all.

The proposal which would reduce by three percentage points federal matching rates for optional services for the categorically needy and for all services for optional groups, including the medically needy, would cut federal Medicaid expenditures for FY 83 by $600 million.

The term "optional" with regard to these services and beneficiaries is to some extent misleading, for they are neither frivolous nor luxury items. The majority of Medicaid eligible nursing home patients are classified as medically needy; patients in intermediate care facilities (ICF's) comprise the primary optional service. In 1979, nearly 61% of the Medicaid payments in these two areas were for long term care services.

We feel compelled to point out that these two reductions, in addition to the 4% reduction in federal Medicaid payments mandated last year by Congress, would concentrate inequitably on one specific beneficiary population: elderly nursing home patients on Medicaid.

The attached chart, prepared by the Congressional Research Service shows the extent of the impact of these two reductions on states in FY 83.

As pointed out earlier, the uncertainties and apprehensions that attend the budget making process each year, whereby each group of beneficiaries and providers receives smaller and smaller pieces of the same pie, or none at all, mandate significant changes in the structure of that system, rather than a continuation of the old one. One major element of that change would be the federalization of Medicaid.

Medicaid Co-Payments

The Administration's FY 83 budget proposal includes a provision requiring nominal copayments on a variety of health services. These include a $1 per visit copayment on the categorically needy and a $1.50 per visit copayment on the medically needy for physician, clinic and hospital outpatient department services. In addition, a $1 and $2 copayment per day would be required of the categorically and medically needy respectively, for inpatient hospital services.

We support the concept of cost-sharing and believe that these modest amounts should not impose undue hardships on beneficiaries. At the same time, we believe that by participating in the expenses of their health care, rather than receiving it cost-free, will serve to make Medicaid recipients more cost-conscious and perhaps act as somewhat of a barrier to unnecessary utilization or over-utilization.

Supplementation

Included in the FY 83 budget are plans for proposed regulations to allow states, under their laws of general applicability, to require adult children of institutionalized Medicaid recipients to contribute to the cost of their parents' care.

The National Council has previously endorsed the concept of shared responsibility through private supplemental payments for the cost of Medicaid patients' nursing home care.

We believe that states, patients, and their families should have that flexibility, given the shortages being experienced in state Medicaid funds. At the same time, families have expressed a desire to contribute a nominal amount for their elderly relatives' care. An added positive benefit would be the involvement of those families in purchasing nursing home services and in assuring that quality care is delivered.

It should be noted that numerous states have been moving in this direction, by requesting necessary waivers from the Health Care Financing Administration and by seeking federal and state legislation. As an example of the extent family supplementation can alleviate a portion of the Medicaid burden, in 1976 when the federal government ended the practice of allowing supplementation, Tennessee's intermediate care facility budget increased by 28%. Relatives of nursing home patients as well as friends, churches, philanthropic groups, and counties had been allowed to contribute funds to the facility to supplement the state's basic rate for Medicaid care.

We feel strongly that this option must be available to states in order to avoid possible cutbacks in staffing and services to nursing home patients.

Federalization of Medicaid

President Reagan has proposed what has been called a major "swap" of federal and state programs. One component of that swap is the full assumption of the Medicaid program by the federal government beginning in FY 84.

The Board of Directors of the National Council of Health Centers has given its endorsement of the President's proposal with the caveat that it not be modeled after the Medicare program's overly complex payment system and administrative structure. We would also predicate our support upon the ability of the states and the federal government to reach an agreement as to which services are to be assumed by the federal government and at what level of expenditure as well as a uniform eligibility standard.

In conjunction with the federalization of Medicaid, we urge consideration of the steps necessary to establish a national policy for long term care. It is appropriate that these two actions be taken simultaneously and that they are entirely compatible. We feel that the impending fiscal crisis in the Social Security Trust funds, as well as that already being experienced in Medicaid, force some drastic and far-reaching changes to be made.

As mentioned earlier, we feel it is vital to restructure the financial supports of long term care into a more pluralistic system in which competition would play a key role. To this end, we strongly support the adoption of the principles of competition in that system and the incorporation of the same competitive purchasing practices for Medicare and Medicaid beneficiaries as presently exist for private patients seeking nursing home care. There are a number of ways of instilling competition at the Medicare/Medicaid consumer's point of purchase, such as the use of vouchers.

Further in seeking alternative funding mechanisms we should consider the many imaginative proposals available such as:

- Tax incentives to encourage the development of private insurance plans for long term care, including coverage of supplemental payments and coinsurance premiums.

- Inheritance tax policies which recognize individuals' financial commitments and responsibilities in providing for the care of their elderly family members in their homes and appropriate health centers.
- Establishment of self-help programs such as subsidized reverse mortgages in which individuals could borrow on the equity in their residence to assist in the payment for their long term health care costs.
- Taxing programs with revenues being totally dedicated to long term health care for the elderly such as excise taxes on liquor and cigarettes.
- Tax credits recognizing the fees of condominiums dedicated to congregate living under life health care plans.
- Allow tax credits for increased contributions to IRAs, KEOGHs, and pension funds if they are dedicated for the support and payment of long term care after the individual reaches the age of retirement.

Conclusion

The Administration has had to make some difficult decisions with regard to its fiscal year 1983 budget proposals. No segment of the Medicare/Medicaid provider and beneficiary population will remain untouched or unaffected by the changes and some of these cuts will result in hardships.

President Reagan has recognized that this process cannot continue, and so has set in motion discussions and proposals for sweeping changes in the Medicare and Medicaid programs. The National Council believes that the debate on these changes is an appropriate opportunity as well for discussion of some necessary fundamental changes in our long term care system. We urge its inclusion on the debate.

TABLE 3

PRELIMINARY ESTIMATE OF IMPACT OF FY 1983 ADMINISTRATION MEDICAID PROPOSAL ON FEDERAL MEDICAID REIMBURSEMENT TO STATES.
ADMINISTRATION PROPOSAL WOULD REDUCE THE FEDERAL MATCHING RATE BY THREE PERCENTAGE POINTS FOR ALL SERVICES PROVIDED TO NON CASH WELFARE RECIPIENTS AND FOR OPTIONAL SERVICES PROVIDED TO CASH WELFARE RECIPIENTS.

(DOLLARS ARE IN THOUSANDS)

STATE	STATE ESTIMATE OF FY 1983 FEDERAL PAYMENTS (NOV. 1981)	FEDERAL PAYMENTS AFTER 3 PERCENTAGE POINT REDUCTION	LOSS FROM REDUCTION	4 PERCENT P.L. 97-35 REDUCTION	COMBINED LOSS FROM BOTH REDUCTIONS (EXCLUDED REBATES)
ALABAMA	281,656	275,319	¯6,337	264,306	¯17,350
ALASKA	31,843	31,325	¯518	30,072	¯1,771
ARIZONA					
ARKANSAS	258,195	252,286	¯5,909	242,195	¯16,000
CALIFORNIA	2,326,017	2,259,410	¯66,607	2,169,034	¯156,983
COLORADO	154,335	150,713	¯3,622	144,684	¯9,651
CONNECTICUT	252,021	241,662	¯10,359	234,412	¯17,609
DELAWARE	35,310	34,244	¯1,066	32,874	¯2,436
DIST. OF COL.	118,365	114,724	¯3,641	110,135	¯8,230
FLORIDA	405,206	395,891	¯9,315	380,055	¯25,151
GEORGIA	465,211	453,431	¯11,780	435,294	¯29,917
HAWAII	80,974	78,506	¯2,468	75,366	¯5,608
IDAHO	50,540	49,039	¯1,501	47,077	¯3,463
ILLINOIS	839,850	808,795	¯31,055	776,443	¯63,407
INDIANA	360,622	350,899	¯9,723	336,863	¯23,759
IOWA	183,668	177,721	¯5,947	170,612	¯13,056
KANSAS	137,527	131,686	¯5,841	126,419	¯11,108
KENTUCKY	323,674	316,414	¯7,260	303,757	¯19,917
LOUISIANA	467,621	457,639	¯9,982	439,333	¯28,288
MAINE	156,330	153,124	¯3,206	146,999	¯9,331
MARYLAND	313,301	305,365	¯7,936	296,204	¯17,097
MASSACHUSETTS	732,906	706,114	¯26,792	684,931	¯47,975
MICHIGAN	853,031	827,345	¯25,686	802,525	¯50,506
MINNESOTA	505,634	489,272	¯16,362	469,701	¯35,933
MISSISSIPPI	268,383	263,088	¯5,295	252,564	¯15,819
MISSOURI	331,016	322,966	¯8,050	310,047	¯20,969
MONTANA	64,504	62,784	¯1,720	60,273	¯4,231
NEBRASKA	94,127	91,302	¯2,825	87,650	¯6,477
NEVADA	53,042	51,892	¯1,150	49,816	¯3,226
NEW HAMPSHIRE	66,382	64,231	¯2,151	61,662	¯4,720
NEW JERSEY	544,017	524,713	¯19,304	508,972	¯35,045
NEW MEXICO	90,432	88,852	¯1,580	85,298	¯5,134
NEW YORK	3,670,699	3,545,639	¯125,060	3,439,270	¯231,429
NORTH CAROLINA	461,293	451,025	¯10,268	432,984	¯28,309
NORTH DAKOTA	56,203	54,908	¯1,295	52,712	¯3,491
OHIO	797,944	777,680	¯20,264	746,573	¯51,371
OKLAHOMA	272,929	265,855	¯7,074	255,221	¯17,708
OREGON	126,136	121,188	¯4,948	116,340	¯9,796
PENNSYLVANIA	1,107,875	1,080,672	¯27,203	1,037,445	¯70,430
RHODE ISLAND	123,721	119,347	¯4,374	115,767	¯7,954
SOUTH CAROLINA	244,151	237,509	¯6,642	228,009	¯16,142
SOUTH DAKOTA	55,159	53,718	¯1,441	51,569	¯3,590
TENNESSEE	462,193	452,745	¯9,448	434,635	¯27,558
TEXAS	880,136	855,533	¯24,603	821,312	¯58,824
UTAH	90,896	88,791	¯2,105	85,239	¯5,657
VERMONT	60,695	59,150	¯1,545	56,784	¯3,911
VIRGINIA	303,925	294,772	¯9,153	282,981	¯20,944
WASHINGTON	241,048	232,514	¯8,534	225,539	¯15,509
WEST VIRGINIA	117,466	115,231	¯2,235	110,622	¯6,844
WISCONSIN	694,239	675,811	¯18,428	648,779	¯45,460
WYOMING	13,637	13,249	¯388	12,719	¯918
TOTALS	20,626,085	20,026,089	¯599,996	19,290,073	¯1,336,012

TABLE PREPARED BY CRS. ESTIMATES ARE SUBJECT TO LIMITATIONS OF DATA AND THE ASSUMPTIONS USED IN ESTIMATION. DETAIL MAY NOT SUM TO TOTALS DUE TO ROUNDING

NOTE: BASIC DATA PROVIDED BY HEALTH CARE FINANCING ADMINISTRATION. TOTAL IMPACT OF THREE PERCENTAGE POINT REDUCTION IS ESTIMATED AT 600 MILLION DOLLARS IN FY 1983 BY THE ADMINISTRATION. THIS TOTAL WAS DISTRIBUTED ACROSS STATES ON THE BASIS OF CALCULATIONS DONE ON FY 1980 DATA

Joint Statement of Mr. James Vincent
and Mr. Lonnie Hollingsworth
Before the Senate Finance Committee
March 12, 1982

HHS/HCFA 1983 Budget

Mr. Chairman, Members of the Senate Finance Committee:

I am James Vincent of Yuma, Colorado. My colleague is Lonnie Hollingsworth of Lubbock, TX. We serve respectively as Chairman of the Executive Committee and Chairman of the National Legislation and Government Affairs Committee of the National Association of Retail Druggists.

The National Association of Retail Druggists (NARD) represents owners of more than 30,000 independent pharmacies, where over 75,000 pharmacists dispense more than 70 percent of the nation's prescription drugs. Together, they serve 18 million persons daily and provide nearly 90% of the Medicaid pharmaceutical services. NARD has long been acknowledged as the sole advocate for this vital component of our free-enterprise system.

NARD members are primarily family businesses. They have roots in America's communities. The neighborhood independent druggist typifies the reliability, stability yet adventuresomeness that has made our country great.

As owners of independent pharmacies, our members are committed to legislative and regulatory initiatives designed to provide them a fair chance to compete. We especially appreciate the opportunity to appear before the Committee on the proposed Fiscal Year 1983 HHS/HCFA Budget, especially the Medicaid program.

We believe that one of the major strengths in the health care system is the thousands of independent community pharmacies readily accessible to virtually every segment of the population. Any revisions in the Medicaid health care program should capitalize on the strengths of the existing retail distribution network for drugs. It provides maximum access and professional services unknown to non-professional government dispensaries or mail order vendors.

In consideration of the proposals before the Committee, we ask that prescribed drugs be retained as an integral part of a basic health care package. What good is there in making the services of a physician available to diagnose an illness, and making diagnostic laboratory services available to assist the physician, if after these procedures and services are completed, the necessary drug therapy indicated to properly treat the illness is not also available. It just doesn't make sense to expend the time and resources on a diagnosis for which therapy cannot be provided. And it does not make any more sense to institutionalize a patient to assure that drug therapy indicated will be provided.

In contrast to most, if not all other Medicaid services delivery systems, competition in retail pharmacies is alive and well. Not only are prescription drug prices well below the general consumer price index for the past two decades, but they are significantly lower than the index for all other medical care reimbursed by Medicaid:

Since 1960 CPI up for:
All consumer prices: 178%
Medical care prices: 236%
Prescription prices: 34%.

We maintain this is significant evidence that our members, who are filling 70 percent of the nation's prescriptions, have kept faith with the public and the government. We further submit these results emphasize that American competition is still a tribute to our democracy. Competition is an incentive for efficiency and the price competition in retail pharmacy is greater than can be found among the other providers of health services.

Reagan Medicaid Proposals

We find the low priority assigned to the Medicaid pharmacy program by the Reagan Administration FY '83 HHS budget troublesome. The proposed 3% reduction must be rejected as short-sighted.

Even if one were to disagree with our assessment of the cost-effectiveness of this Medicaid component little savings could be realized by reductions in this area. The Congressional Budget Office, for example, in its recent "Medicaid-Choices, for 1982 and Beyond" concluded that the total medical optional services, of which drugs is only one, have had little effect on total Federal Medicaid cost. If savings are to be realized they must be found in the components that have kept the medical price index, while ahead of the general consumer price index, not prescription drugs.

Additionally, it is well known that any barrier to a prescription creates a Medicaid cost -- emergency hospital service or prolonged illness -- ten or more times in excess of fair competition to a pharmacy provider.

Needless to say, NARD was pleased by the Committee's March 2, 1982 endorsement of the President's level of cuts, but rejection of specifics, such as the 3% cut in the pharmacy program. Likewise, we commend the Administration for not resurrecting the theoretical volume purchase plans, like that recently terminated for inherent excessive overhead in California.

Additionally, some aspects of the '83 proposal, which shift administrative activity to the states, seem inconsistent with the '84 proposed swap of Medicaid and the AFDC and Food Stamp programs. In any case, NARD views fair reimbursement for these products and services as essential whether or not Medicaid is Federalized. Medicaid could not succeed without this preventive service that helps to cut hospital, nursing home and physician costs.

Pharmacy Reimbursement

Today there are many problems confronting independent pharmacists servicing Medicaid patients. Fixed dispensing fees -- inadequate to begin with -- are based on out-of-date information.

States reimburse pharmacists on a product-cost plus dispensing-fee basis. Fees are determined by state Medicaid agencies. States are required by regulations to conduct surveys of costs of filling prescriptions; but, since they are not required to use the survey data, states can establish fixed dispensing fees at whatever rate they choose. So far, fixed fees have always been below the average dispensing cost.

When states do make required surveys, the data are obviously 12 months old when collected. By the time they are analyzed, they are a minimum of two years old. By the time states get around to granting fee increases, the data is three years old. It is not rare for dispensing fees to be three years out-of-date by the time increases are granted, even if based on a required survey.

Further, services provided Medicaid patients are not paid for by Medicaid. Services such as 24-hour emergency prescription service, free delivery, maintenance of patient profiles and consultations are of no intrinsic value where Medicaid is concerned. Yet, Medicaid patients expect and depend upon these services, the same as cash-paying customers. Additionally, states never consider reasonable profits or return on investment. By not including compensation for investments pharmacists have in inventories, fixtures and buildings in these days of exhorbitant interest rates, the fixed dispensing fee becomes a luxury that many pharmacists cannot afford.

Few states grant annual fee increases to pharmacists. Considering the rate of inflation over the past ten years, pharmacists are in serious trouble.

Another problem with the Medicaid program is inadequate state appropriations. When states prepare annual budgets, anticipating providing increased fees to pharmacists, additional funds allocated for possible fee increases are usually used up by increases in wholesale costs of drug products.

Manufacturers can raise their prices at will. What happens when a manufacturer raises a price? Generally, a letter is sent to pharmacists stating their prices today when up 10 percent. If the pharmacist has to order the medication the next day, the new price is 10 percent higher.

Because states are slow in changing their records, new wholesale prices are not reflected in the states' computers for 30 to 90 days. Therefore, if there is a 10 percent increase (say the price of a product goes from $10.00 to $11.00 per 100 tablets) and the pharmacist fills the prescription for 100, with a $2.50 fee, the pharmacist has lost $1 because the state has not changed its computer records. In effect, the pharmacist gets a fee of $1.50, not $2.50.

When states do change their records updating drug prices, money previously allocated for their Medicaid programs is used up quickly. Nothing is left to increase pharmacists' dispensing fees and they are left with fee schedules that may be one to six years out-of-date.

This system of reimbursement recognizes no variation in operation expenses or variation in professional services or professional competence. The more experienced attorney or physician usually charges more and is allowed more under any system because of more professional or specialized experience. The professional fee for prescriptions recognizes no difference in professional abilities but allows the same fee for a prescription filled by a recent graduate that is allowed when the pharmacist has had years of valuable pharmacy experience. Once again, we find that the pharmacy points of view vary significantly depending on what is invested. The store owner must be conservative, be proud of our profit system and have an adequate return on the investment; consequently, our owners recommend the elimination of inflexible mandatory fixed fees. NARD recommends that the pharmacist be reimbursed under Medicaid at a level at least as high as a store would charge their private patients.

Payment - Delay

After pharmacists fill prescriptions and submit claims to the state, they must wait for reimbursement. HCFA has promulgated regulations requiring states to pay 90 percent of all "clean" claims within 30 days. However, since these regulations have no enforcement provisions, if a state either does not want to, or cannot -- because of budget problems -- reimburse the pharmacist in a timely fashion as required by regulations, reimbursements can be delayed indefinitely or forgotten.

When a state runs out of money, as a number of states have, pharmacists are being asked to continue underwriting the Medicaid system until money becomes available. Medicaid was not designed to be a charity for states. It was designed to provide health care to those families who cannot afford it and allow reasonable profits to providers of Medicaid services.

Reimbursement rates today are well below what they should be. It is difficult to stay in business when you are losing money on every prescription. These problems are not restricted to Medicaid. Private, third-party prescription programs follow in Medicaid's footsteps. Whatever Medicaid gets away with the private carriers do too. Therefore, pharmacists are being used as "whipping boys" with fees kept far below what they should be if independent pharmacists are to stay in business.

Mr. Chairman, apparently Health Care Financing Administration bureaucrats are totally unaware of how competitive retail pharmacy really is. Other segments of the health-care system are not competitive at all. However, in the retail pharmacy business, if your prices are too high, consumers go down the street to a chain drugstore or another independent. If chain prices are too high, consumers will patronize the independent. Because drugstores are conveniently located in neighborhoods as stated before, we are the health-care professionals most often seen by patients. Despite this, all of the problems being created by Medicaid continue to reduce the number of independent pharmacies in business.

Maximum Allowable Cost

The Health Care Financing Administration, trying to reduce prescription costs, has placed regulations in effect under the Maximum Allowable Cost program (MAC) and the Estimated Allowable Cost (EAC). The MAC program is 10 years too late.

In today's market, considering the number of generics available, and the required drug-substitution laws effective in many states, the MAC program is ineffective or unneeded.

Another problem with the EAC and MAC is they offer no incentive for pharmacists to save on procurement. They are penalized for buying in quantity to obtain lower prices, since they do not share in the profits resulting from quantity-buying. A pharmacist could invest money to buy in larger quantities to save the customers money while making profit, but, MAC and EAC prevent this from happening with Medicaid. So why should pharmacists buy in larger quantities?

Is There A Better Way

We believe there is a better way -- there must be. We are in the process of analyzing the problem of overall pharmaceutical costs, not only to recipients of Medicaid but to the general public as well. We have established the following criteria:

- Any cost-reduction program should not disrupt the current drug-distribution system which has provided our nation the best health-care record in the world;

- Medicaid patients must not be relegated to positions of second-class citizenship by being denied freedom to select their own health-care providers and choose the sources of their prescription drugs and pharmaceutical services the same as any other citizen;

- To be acceptable, any cost-reduction program should not discriminate against small-business owners nor be detrimental to independent retail pharmacy;

NARD urges the elimination of the fee for services reimbursement and supports legislation requiring states to pay marketplace prices for prescription drugs. Marketplace prices would enable pharmacies to be reimbursed for the services and products supplied. Medicaid patients would benefit because more independent pharmacies would remain in business and available to provide needed services.

NARD recommends a direct payment approach for these products and services. Possible models include the following:

a) Coupons such as those provided by the USDA for the purchase of food;

b) Health care vouchers drawing on concepts such as those of the Gephardt Competitive Health bill, H.R. 850;

c) Retail vouchers redeemable for products under the Federal program for Women, Infants and Children (W.I.C.); or

d) The Delaware Prescription Drug Draft Program under which eligible persons submit a check to the pharmacy provider which is endorsed and deposited the same as any check received by the provider from a patient for pharmaceutical services. The draft, however, cannot be cashed.

NARD believes that reliance on market forces will yield savings. The high administrative cost of the pharmaceutical services program, relative to the cost of the services, could be greatly reduced. The chronic problems associated with late payments would be eliminated. Competition would be enhanced and prudence amongst Medicaid recipients would be encouraged. Likewise, fraud and waste made possible solely because of the unnecessary, complex way in which the program has been implemented would be eliminated.

Mandatory copay could be easily added to such a system. Cost sharing could take the form, for example, of a 5% or 10% contribution towards the pharmaceutical voucher/draft/coupon.

NARD likewise agrees that retention of recipient freedom of choice as to pharmacy provider is essential, not only to assure the widest access to quality care but to assure maximum reliance on marketplace that will in return yield taxpayer savings.

NARD also supports the following interim steps until the fee for service reimbursement is eliminated:

a) Full implementation of the "Cost of Filling a Prescription" surveys;

b) Interest and penalties for late payment;

c) Compensation for the variety of services -- in addition to prescriptions -- actually provided by professional pharmacies; and

d) Reinstatement of the recently revoked 60-day public notice for state changes in Medicaid reimbursement method or level of reimbursement.

Lastly, it is absolutely essential to assure that the providers of services in such a competitive market as retail drugs, have a key role in the design, operation and administration of the Medicaid program.

In the past, a small group of career bureaucrats -- most who never met a payroll in their lives -- have met behind closed doors, without pharmacy provider insight and developed Medicaid policy, legislation and excessive regulations.

Without such an opportunity to participate in the fashioning of the Medicaid program, providers, such as our members, will be left totally to the whim of totally unrestrained bureaucrats.

NARD seeks the support of the Finance Committee for our recommendations and pledges to assist its members and staff in the refinement of our proposals to make Medicaid more cost effective.

# # #

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March 4, 1982

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Robert E. Lighthizer,
Chief Counsel
Committee on Finance
Room 2227
Dirksen State Office Building
Washington, D.C. 20515

Re: Proposed SSI Cuts Recommended for FY 83

Dear Mr. Lighthizer:

This organization sees over 1500 elderly individuals each year here in Maine. Of these, a very large number are SSI recipients. The cuts which the Administration has proposed for Fiscal 83 will have a dramatic and drastic effect on their standard of living. On behalf of these clients, I am writing to oppose these cuts. I will discuss them sequentially.

(1) Rounding down benefits and paying benefits only back to the day of application, rather than to the first day of the month in which the application is filed.

The proposal to round down benefits can only seem innocuous in the context of personal budgets of $10,000, $20,000, $30,000 or more dollars per year. In such a context, opposition to rounding down might seem like quibbling over trifles. In the context of an annual income of less than $4,000 per year, the aggregate loss of those pennies has a proportionately significant impact on the monthly budget.

The proposal to pay only to the date of application is a more drastic issue. People are not newly poor at the time of application. Often they have been struggling for some time before they get to the point where requesting public aid is the only alternative. Also, there are fixed monthly costs, and often people have not been able to pay them for the month in which they apply because they have had no income for some time. The dislocation caused by having to leave a rental because you can't pay that one month's rent is much more important than any savings that might accrue by waiting until the date of application for payment. Further, especially in this rural State, people cannot always get into an office on the first of the month. There are specified days for intake when representatives ride out to the rural areas to take applications. For our homebound clients, this rule will work in a special hardship.

(2) Disability must last two years and the impairment must be "generally disabling."

The two-year duration rule is completely irrational in the context of a needs-based program. The need exists in the present, even if the disability may lessen in the future and enable the person to work. People with short-term disabilities are no less needy than people with long-term disabilities, during the entire period of disability.

The medical severity of an impairment, and its impact on an "average" person is an ivory tower approach to the real problems facing our clients. We have women who have been divorced by their husbands late in life, who are between 60 and 65 with no work record, and for whom a variety of impairments preclude their ability to sustain themselves in the job market. To say that they must nonetheless meet some artificial standard of medical severity, as applied to people with average work histories, is to ignore the reality of their lives, and make the promise of assistance for those in need a hollow one.

(3) Elimination of $20 disregard.

This is just another way of cutting money out of the pockets of individuals who are not receiving an adequate income to sustain themselves as it is. In effect, for the many widows whom we represent who have only $150 or so dollars from their husband's account in Social Security, this means cutting their SSI benefits by $20 per month. This in many instances will result in a 5% or more decrease in benefits in an already inadequate benefit.

(4) Recover SSI overpayments out of Social Security Benefits.

There are two policies which would be violated by allowing SSI overpayments to be recovered out of Social Security benefits. One is the policy that has been in Social Security since it was enacted, which is that no attachment may be made of these benefits for creditors, because they were understood to be only a supplement as it was, and should be inviolate from the claims of creditors. Equally importantly, however, is the principle that SSI overpayments should not be recovered from individuals whose income is so low that to do so would be a hardship. If you take away a person's SSI, and have only left their Social Security, by definition they have less than what they had when they had their SSI. Accordingly, if anything, they are suffering a greater hardship, and they should be allowed to retain the meager residual.

Thank you very much for this opportunity to comment.

Sincerely,

Nancy Brockway

Nancy Brockway
Chief Attorney

NB:am
cc: Barbara Leyser

[illegible]

March 12, 1982

PROPOSED CUTS IN AFDC FOR FY 83

Mr. Robert E. Lightnizer
Chief Counsel
Committee on Finance, Room 2227
Dirksen Senate Office Building
Washington, DC 20515

I am going to address each issue and give you my thoughts on these cuts most of them are not favorable therefore if you do not want to read anything disfavorable please discard right now.

States would be required to pay less than full benefits whenever an AFDC recipient live in a household with others. To me this really smacks of treating those on AFDC as non-citizens. Let me use a comparison. The administration did not do anything for a long time regarding the Southeast Asians who came to America and were paid very well for 2-3 years (I believe it was 3) and it was OK for them to live together but when an AFDC person lives with others benefits are to be cut. As a citizen and taxpayer I cannot justify this when I think of the above statement.

States would also be required to count the income of all adults living in the household who are not related to the AFDC children as income to the children. I am not sure I fully understand this statement but it seems to me that it simply means that kids are going to be supporting kids which both you and I know is wrong.

States would be required to count energy assistance recieved by AFDC recipients as income so that the amount of their AFDC benefits would be reduced a dollar for each dollar that they recieve in energy assistance. Most people on AFDC do not even get enough to pay for all of their energy costs in the first place because their income is so low. Are you going to penalize them because they do not recieve a decent living check from the people who tell us what the standard of living is? This is really ludricious! I am a working person on a low income and I can barely get by, how do you expect the people on AFDC to when electricity and gas etc. is going up all the time.

Family benefits would be reduced when the youngest child reaches 16 . Just because a child reaches 16 he/she doesn't quit eating and parents do not cease to be parents. Agreed she should look for work and if she can find it in this depressed economy she should and I am sure would take that job rather than be embarrassed when people ask you what you do for a living. This also affects the kids pride in themselves and their parents, so if we don't pay for it one way we can expect to pay for it through more prisons etc. I and many, many other people would love to see work relief programs but the states simply do not have the money to finance them so maybe between the states and the Federal Government a work relief system could be set up. It does noone good to be idle. A price freeze and lowering of prices so people could afford to buy the necessities of life is a suggestion I feel is necessary if we are going to get the money flowing. The rich don't support the majority!, we

Minor children who have income of their own such as social security benefits based on the earnings of a deceased parent would be forced to contribute that income to meet the needs of their siblings. As long as the one parent does not re-marry I feel he is entitled to these benefits to him/herself. Should the parent marry all benefits would be stopped since this is a two parent family again. I am willing to pay taxes where I feel there is a good justification but not if there is a good justification. For instance, I cannot see and here I agree with the administrations efforts to cancel college funds just because you happen to have a dead parent. I am divorced and supporting my children myself and cannot afford (nor can the children afford) a luxery as college is.

The program of emercency assistance for families would be eliminated. People are already in an emergency when they apply for emergency assistance and need this assistance probably now more than six month away in order to survive.

States would also be required to round benefits to the next lowest dollar and would be barred from paying benefits for any period prior to the date of application . I cannot see the great savings in this but agree in principal.

I am just going to generally lump all of the PROPOSED CUTS IN SSI FOR FISCAL YEAR 1983 together. As a citizen I can see this as a humilitating thing and a dehumanizing experience. First of all noone wants to be on SSI in the first place, and I must add that I can remember the time before it was begun and we did just fine without it then. Let's go back to Social Security responsible for all and try and get the mess straightened out in the Social Security Department and then we can maybe consider some of the proposed rules. They are, to me, at the present time just a bunch of "stupid" lines on paper.

I do hope this will be read and some consideration, as much as anyone else's opinions, will be considered. This goes for those who hold office too for I feel that as a citizen of the United States my opinion still counts and it should be heard and listened to.

Thanks for bearing with me to the end of this letter.
I would appreciate a response to this letter and these thoughts.

Sincerely ,

Marlene A. Byrne
644 SE 148 Apt 4
Portland, OR 97233

TESTIMONY OF
THE CATHOLIC HEALTH ASSOCIATION OF THE UNITED STATES

ON

THE ADMINISTRATION TAX PROPOSAL WITH RESPECT TO
TAX-EXEMPT FINANCING

SUBMITTED TO
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

THE CATHOLIC HEALTH ASSOCIATION (CHA) REPRESENTS 633 CATHOLIC HOSPITALS HAVING 169,928 BEDS AND 260 LONG-TERM CARE FACILITIES HAVING 32,670 BEDS. THESE HEALTH CARE FACILITIES ARE SPONSORED BY RELIGIOUS ORDERS AND DIOCESES OF THE CATHOLIC CHURCH.

CATHOLIC HOSPITALS CAN BE FOUND IN THE INNER CITIES SERVING LARGE PROPORTIONS OF MEDICARE, MEDICAID AND CHARITY CARE PATIENTS. CATHOLIC HOSPITALS CAN BE FOUND SERVING RURAL COMMUNITIES. CATHOLIC HOSPITALS CAN BE FOUND AMONG THE RANKS OF THE TEACHING HOSPITALS AND THE TERTIARY CARE CENTERS.

BECAUSE OF THE LEVEL OF COMMUNITY SERVICE REPRESENTED BY CATHOLIC HOSPITALS AND THE IMPORTANCE OF TAX-EXEMPT FINANCING TO A CONTINUATION OF THAT SERVICE, THE ASSOCIATION WILL FOCUS ITS TESTIMONY ON THOSE ASPECTS OF THE ADMINISTRATION'S TAX PROPOSAL THAT DEAL WITH TAX-EXEMPT FINANCING.

TAX-EXEMPT BONDS FOR PRIVATE ACTIVITIES

THIS PART OF THE ADMINISTRATION'S TAX PROPOSAL FOCUSES ON THE USE OF TAX-EXEMPT BONDS BY ENTITIES OTHER THAN UNITS OF GOVERNMENT.

THE ADMINISTRATION'S PROPOSAL ON TAX-EXEMPT BONDS WOULD PLACE RESTRICTIONS ON THE ISSUANCE OF ALL TAX-EXEMPT BONDS ISSUED BY UNITS OF STATE AND LOCAL GOVERNMENT FOR OTHER THAN THEIR OWN USE. THE APPLICATION OF THE ADMINISTRATION'S PROPOSAL COVERS A WIDE RANGE OF TYPES OF BONDS, FROM SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, TO STUDENT LOAN BONDS, TO BONDS

USED TO FINANCE CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS.

CHA HAS REVIEWED THE ADMINISTRATION'S TAX-EXEMPT FINANCING PROPOSAL, AND ASSESSED THE IMPACT OF THAT PROPOSAL ON TAX-EXEMPT FINANCING OF CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS. IT IS OUR CONCLUSION THAT ELEMENTS OF THE ADMINISTRATION'S PROPOSAL COULD HAVE A SEVERE AND ADVERSE IMPACT ON ACCESS TO CAPITAL FINANCING OF NOT-FOR-PROFIT HEALTH CARE FACILITIES.

TO SUPPORT THAT CONCLUSION, OUR TESTIMONY WILL:

1. IDENTIFY THOSE PARTS OF THE ADMINISTRATION'S PROPOSAL THAT IMPACT TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES.
2. DELINEATE CHA'S GENERAL AND SPECIFIC CONCERNS WITH THE ADMINISTRATION'S PROPOSAL.
3. WITH REGARD TO HEALTH POLICY, MAKE THE CASE THAT:
    A. THERE ARE NO HEALTH POLICY CONSIDERATIONS WHICH WOULD PROVIDE SUFFICIENT JUSTIFICATION TO WARRANT RESTRICTING ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HOSPITALS.
    B. THERE ARE A NUMBER OF HEALTH POLICY CONSIDERATIONS WHICH WOULD MORE THAN JUSTIFY PRESERVING ACCESS TO TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES.

CHA CONCLUDES WITH A REQUEST THAT IF THE SENATE COMMITTEE ON FINANCE BELIEVES IT MUST AMEND THOSE PORTIONS OF THE TAX STATUTE THAT DEAL WITH TAX-EXEMPT FINANCING, IT DO SO WITHOUT IMPACTING ADVERSELY ON NOT-FOR-PROFIT HOSPITALS' ACCESS TO THAT FINANCING.

ELEMENTS OF THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL WHICH WOULD AFFECT NOT-FOR-PROFIT HOSPITALS

THE PROPOSAL WOULD IMPOSE SEVERAL ADDITIONAL REQUIREMENTS ON STATE AND LOCAL GOVERNMENTS ISSUING TAX-EXEMPT BONDS FOR "PRIVATE PURPOSES", WHICH WOULD INCLUDE THE CAPITAL FINANCING FOR A NOT-FOR-PROFIT HEALTH CARE FACILITY.

1. THE HIGHEST ELECTED OFFICIAL OR LEGISLATIVE BODY OF THE GOVERNMENTAL UNIT ISSUING THE BONDS AND IN WHICH THE PROJECT IS LOCATED MUST FIRST HOLD A PUBLIC HEARING ON THE WORTH OF THE PROJECT, AND THEN IT MAY APPROVE THE BONDS.
2. IN CASES OF BONDS ISSUED AFTER 1985, THE UNIT OF GOVERNMENT ISSUING THE BONDS MUST MAKE A FINANCIAL CONTRIBUTION, COMMITMENT OR OBLIGATION TO THE CAPITAL PROJECT FOR WHICH BONDS ARE BEING ISSUED. THE FINANCIAL CONTRIBUTION MUST BE EQUAL TO 1% OF THE FACE VALUE OF THE BONDS.
3. POSITIVE ARBITRAGE WILL NOT BE PERMITTED. TREASURY WILL NOT PERMIT A RETURN ON FUNDS RAISED THROUGH THE ISSUANCE OF BONDS AND INVESTED DURING THE CONSTRUCTION PERIOD GREATER THAN THE INTEREST RATE ON THE BONDS.

WHILE THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL INCLUDES SEVERAL OTHER REQUIREMENTS, THEY DO NOT APPEAR TO AFFECT TAX-EXEMPT FINANCING FOR CAPITAL PROJECTS OF NOT-FOR-PROFIT HEALTH FACILITIES.

CRITIQUE OF THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL

CHA'S CONCERNS WITH THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL ARE BOTH GENERAL AND SPECIFIC.

GENERAL:

CHA IS CONCERNED THAT:

- TREASURY HAS DEVELOPED A BROAD BRUSH PROPOSAL TO SOLVE PROBLEMS PERCEIVED WITH A SPECIFIC TAX-EXEMPT FINANCING VEHICLE.
- TREASURY'S ARGUMENTS IN SUPPORT OF THIS PROPOSAL ARE NOT VALID ESPECIALLY WHEN CONSIDERED IN THE CONTEXT OF TAX-EXEMPT FINANCING FOR CAPITAL PROJECTS FOR NOT-FOR-PROFIT HOSPITALS.

"...BROAD BRUSH PROPOSAL...": THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL WOULD APPEAR TO APPLY TO ALL "PRIVATE PURPOSE TAX-EXEMPT BONDS ISSUED BY STATE AND LOCAL GOVERNMENT". ALTHOUGH SECRETARY REGAN'S TESTIMONY BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON FEBRUARY 2 DOES CONTAIN REFERENCES TO POSSIBLE PROBLEMS OR ABUSES WITH SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS (IDBS), THE ADMINISTRATION'S PROPOSAL APPEARS TO BE DEVELOPED MORE FROM A PHILOSOPHICAL PERSPECTIVE THAN IN REACTION TO PERCEIVED PROBLEMS WITH THE VARIOUS TAX-EXEMPT FINANCING VEHICLES TO WHICH THIS PROPOSAL WOULD APPLY. FROM THE AVAILABLE LITERATURE IN SUPPORT OF THE ADMINISTRATION'S TAX PACKAGE, IT WOULD APPEAR THAT THIS PROPOSAL HAS BEEN PUT FORWARD WITHOUT ANY EFFORT ON THE PART OF TREASURY TO ASSESS ITS IMPACT ON THE VARIOUS TAX-

EXEMPT FINANCING VEHICLES TO WHICH IT WOULD APPLY.

CHA HAS ASSESSED THE POSSIBLE IMPACT ON TAX-EXEMPT FINANCING OF CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS AND HAS CONCLUDED THAT ELEMENTS OF THIS ADMINISTRATION PROPOSAL COULD HAVE SEVERE AND ADVERSE IMPACT ON THE ACCESS TO CAPITAL FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES. THE ADMINISTRATION'S PROPOSAL IS ALSO A SOLUTION FOR A PROBLEM OR ABUSE THAT DOES NOT EXIST IN THIS PARTICULAR SECTOR.

TREASURY ARGUMENT: THE TREASURY DEPARTMENT HAS PUT FORTH TWO ARGUMENTS IN SUPPORT OF ITS PROPOSAL. THESE ARGUMENTS ARE THAT INCREASED GROWTH IN THE USE OF TAX-EXEMPT FINANCING HAVE:

- CAUSED HIGHER INTEREST RATES FOR STATE AND LOCAL FINANCINGS; AND,
- CAUSED REVENUE LOSSES TO THE FEDERAL TREASURY.

THESE ARGUMENTS ARE FLAWED AND PARTICULARLY SO WHEN VIEWED IN THE CONTEXT OF TAX-EXEMPT FINANCING FOR CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS.

... HIGHER INTEREST RATES FOR STATE AND LOCAL FINANCINGS: CHA IS UNAWARE OF ANY STUDY WHICH SHOWS THAT INCREASES IN TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HOSPITALS HAS CAUSED OR WILL CAUSE INCREASES IN INTEREST RATES WHICH MUST BE PAID BY STATE AND LOCAL GOVERNMENTS ON THEIR TAX-EXEMPT FINANCING. HOWEVER, IF, AS SUGGESTED BY TREASURY, WE ARE TO SUPPOSE THAT INCREASED DEMAND FOR TAX-EXEMPT FINANCING WILL DRIVE UP INTEREST RATES, THEN SHOULD WE NOT FIRST LOOK TO THE COMPOSITION AND PRIME SOURCE

OF THIS INCREASED DEMAND? IN 1981, MARKET DEMAND WAS:

PUBLICLY OFFERED CORPORATE BONDS	$ 34 BILLION
PRIVATELY OFFERED CORPORATE BONDS	13 BILLION
TOTAL CORPORATE BONDS	$ 47 BILLION
LONG-TERM TAX-EXEMPT BONDS	$ 45 BILLION
SHORT-TERM TAX-EXEMPT BONDS	35 BILLION
TOTAL TAX-EXEMPT BONDS	$ 80 BILLION
U.S. TREASURY ISSUES	$ 93 BILLION
TOTAL PUBLIC BONDS	$173 BILLION

IN THAT SAME YEAR DEMAND FOR HOSPITAL TAX-EXEMPT BONDS WAS $5 BILLION.

FROM THESE FIGURES IT WOULD APPEAR THAT HOSPITAL TAX-EXEMPT BONDS ARE A VERY SMALL PERCENTAGE OF:

LONG-TERM CARE TAX EXEMPT BONDS	11%
ALL TAX-EXEMPT BONDS	6%
ALL PUBLIC BONDS	3%

FROM THESE FIGURES IT WOULD SEEM THAT THE ENTITY HAVING THE MOST EFFECT ON THE BOND MARKET IS THE FEDERAL GOVERNMENT. WITH $93 BILLION IN 1981, IT ACCOUNTED FOR 54% OF THE PUBLIC BOND MARKET. IT WOULD APPEAR THAT THE FINANCING NEEDS OF THE FEDERAL GOVERNMENT HAVE A LARGER EFFECT ON THE INTEREST RATES THAT STATE AND LOCAL GOVERNMENTS MUST PAY THAN ANY OTHER ENTITY IN THE BOND MARKET. THEREFORE, IF INTEREST RATES THAT STATE AND LOCAL GOVERNMENTS MUST PAY IS IDENTIFIED AS A PROBLEM, IT WOULD SEEM TO BE MOST PRODUCTIVE TO LOOK AT THE FEDERAL GOVERNMENT'S OWN ACTIVITIES IN THE BOND MARKET FOR A SOLUTION TO THAT PROBLEM.

IN FACT, RATHER THAN CONTRIBUTING TO THE FINANCIAL PROBLEMS OF STATE AND LOCAL GOVERNMENTS, TAX-EXEMPT FINANCING OF HOSPITALS ACTS TO REDUCE EXPENDITURES AND MAY EVEN INCREASE THE REVENUES OF THESE GOVERNMENTS.

TAX-EXEMPT FINANCING FOR HOSPITALS RESULTS IN:

- LESS EXPENSIVE EMPLOYEE HEALTH INSURANCE PREMIUMS TO STATE AND LOCAL GOVERNMENT.
- LESS EXPENSIVE MEDICAID PROGRAMS FOR STATE GOVERNMENT AND IN SOME CASES COUNTY GOVERNMENT.
- LESS EXPENSIVE GOODS AND SERVICES WHICH STATE AND LOCAL GOVERNMENTS PURCHASE FROM THE PRIVATE SECTOR. (HEALTH INSURANCE FOR EMPLOYEES IS NOT AN INSIGNIFICANT COST OF PRODUCTION.)

IN ADDITION, IN MANY COMMUNITIES THE NOT-FOR-PROFIT HOSPITAL IS ONE OF ITS LARGEST EMPLOYERS. IT MAY ALSO BE AMONG THE LARGEST PURCHASERS OF GOODS AND SERVICES, THEREBY PROVIDING ADDITIONAL JOBS IN A COMMUNITY'S ECONOMY. TAX-EXEMPT FINANCING IS THE PRIMARY SOURCE OF CAPITAL OF MANY SUCH HOSPITALS. IF HOSPITAL ACCESS TO TAX-EXEMPT FINANCING IS RESTRICTED OR CURTAILED, IT CANNOT FAIL TO IMPACT ADVERSELY THE STRONG ROLE WHICH THE HOSPITAL PLAYS IN A COMMUNITY'S ECONOMY.

REVENUE LOSSES TO THE FEDERAL GOVERNMENT: THE ADMINISTRATION IN ITS TESTIMONY BEFORE THE COMMITTEE ON WAYS AND MEANS SUGGESTS PRIVATE PURPOSE TAX-EXEMPT FINANCING REPRESENTS LOST REVENUE TO THE FEDERAL GOVERNMENT. THAT CONTENTION MAY BE ARGUABLE IN GENERAL TERMS, BUT IN THE CONTEXT OF TAX-EXEMPT FINANCING FOR HOSPITALS, IT IS MUCH LESS ARGUABLE.

THE CONGRESSIONAL BUDGET OFFICE HAS ESTIMATED THAT LOSSES IN FEDERAL REVENUES AS A RESULT OF TAX-EXEMPT HOSPITAL BONDS WILL BE $100 MILLION IN FY '82, $200 MILLION IN FY '83 AND $300 MILLION IN FY '84. HOWEVER, THESE PROJECTIONS FAIL TO TAKE INTO CONSIDERATION THAT TAX-EXEMPT HOSPITAL FINANCING REDUCES THE COST TO THE FEDERAL GOVERNMENT FOR:

- MEDICARE,
- MEDICAID,
- HEALTH BENEFITS OF FEDERAL EMPLOYEES,
- CHAMPUS,
- EVERY GOOD AND SERVICE THAT THE FEDERAL GOVERNMENT PURCHASES FROM THE PRIVATE SECTOR.

FURTHERMORE, IF HOSPITALS ARE FORCED INTO THE TAXABLE BOND MARKET IT DOES NOT AUTOMATICALLY FOLLOW THAT THE TREASURY WILL RECEIVE PROPORTIONATE INCREASES IN REVENUES. MANY INVESTORS IN TAXABLE HOSPITAL BONDS SUCH AS PENSION FUNDS ARE THEMSELVES TAX-EXEMPT AND THEREFORE THE INTEREST EARNED ON THEIR INVESTMENTS IS TAX-EXEMPT.

SPECIFIC CONCERNS WITH THE ADMINISTRATION'S PROPOSAL:

CHA'S SPECIFIC CONCERNS RELATE TO THE FOLLOWING PARTS OF THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL:

- ARBITRAGE,
- PUBLIC HEARING AND APPROVAL BY ELECTED OFFICIAL OR LEGISLATIVE UNIT,
- FINANCIAL CONTRIBUTION, COMMITMENT OR OBLIGATION.

ARBITRAGE: THE ADMINISTRATION'S PROPOSAL WOULD EXTEND PROHIBITIONS AGAINST POSITIVE ARBITRAGE TO RESERVE FUNDS AND FUNDS INVESTED DURING THE TEMPORARY CONSTRUCTION PERIOD. UNDER

THE PRESENT LAW AND RULES, POSITIVE ARBITRAGE CAN OCCUR ON RESERVE FUNDS AND INVESTMENTS MADE DURING THE CONSTRUCTION PERIOD.

WITH RESPECT TO INVESTMENTS MADE DURING THE CONSTRUCTION PERIOD, AN EXPLANATION MAY BE HELPFUL.

NOT-FOR-PROFIT HOSPITALS RAISE CAPITAL FUNDS THROUGH FLOATING TAX-EXEMPT BONDS. ON THE DAY CONSTRUCTION BEGINS, THE TRUSTEES FOR THE BOND HOLDERS RECEIVE 100% OF THE MONIES RAISED. SINCE 100% OF THE MONIES RAISED CANNOT BE SPENT ON DAY ONE, THE MONIES ARE OFTEN INVESTED IN SHORT-TERM INVESTMENTS THAT MATURE IN CONCERT WITH THE NEED TO MAKE PAYMENTS DURING THE CONSTRUCTION PERIOD. HOPEFULLY THESE INVESTMENTS ARE MADE IN INSTRUMENTS WHICH RETURN A HIGHER RATE OF INTEREST THAN THE HOSPITAL HAS TO PAY OUT. THE DIFFERENCE IN THE TWO INTEREST RATES RESULTS IN ARBITRAGE.

WITH RESPECT TO RESERVE FUNDS HOSPITALS ARE OFTEN REQUIRED, AS A CONDITION OF THE FINANCING, TO SET UP A DEBT SERVICE RESERVE FUND EQUAL TO ONE YEAR'S DEBT SERVICE ON THE FINANCING. THE MONIES FOR THE FUND ARE DERIVED FROM THE PROCEEDS OF THE BOND ISSUANCE. THE MONIES IN THE FUND ARE INVESTED, HOPEFULLY AT RATES HIGHER THAN THE HOSPITAL IS PAYING ON THE BONDS. ARBITRAGE IS THAT MONEY WHICH IS THE NET RETURN ON THE INVESTMENT AFTER THE HOSPITAL PAYS OUT INTEREST ON THE BORROWED FUNDS.

IF ARBITRAGE IS EXPECTED TO OCCUR AS PART OF THE FINANCING, THE MONIES DERIVED FROM ARBITRAGE ARE INCLUDED IN THE CALCULATION A HOSPITAL AND ITS FINANCING TEAM MAKE WHEN THEY ESTABLISH THE AMOUNT OF MONEY NEEDED TO COMPLETE THE CAPITAL PROJECT. SINCE

THE MONEY DERIVED AS A RESULT OF ARBITRAGE IS USED TO PAY COSTS ASSOCIATED WITH THE PROJECT, THE COST CALCULATIONS ARE LESS THAN WOULD OTHERWISE BE THE CASE. IF THE ADMINISTRATION'S ARBITRAGE PROPOSAL IS IMPLEMENTED IT WILL MERELY CAUSE HOSPITALS TO INCREASE THE AMOUNT OF MONEY TO BE BORROWED TO SUPPORT CAPITAL PROJECTS.

ELECTED OFFICIAL: UNDER THE ADMINISTRATION'S PROPOSAL, THE HIGHEST ELECTED OFFICIAL OR LEGISLATIVE BODY OF THE UNIT OF GOVERNMENT MUST APPROVE THE BONDS. PRIOR TO SUCH AN APPROVAL, A PUBLIC HEARING MUST BE HELD TO GIVE MEMBERS OF THE PUBLIC THE OPPORTUNITY TO COMMENT ON THE CAPITAL PROJECT AND THE BOND ISSUANCE.

HOSPITALS AND NURSING HOMES OFTEN OBTAIN THEIR FINANCING THROUGH AUTHORITIES ESTABLISHED BY UNITS OF STATE OR LOCAL GOVERNMENT. THIS PROPOSAL COULD PROVE TO BE DEVASTATING TO HOSPITALS AND NURSING HOMES THAT USE STATEWIDE AUTHORITIES TO OBTAIN THEIR FINANCING.

THEIR TAX-EXEMPT FINANCING APPLICATIONS WOULD HAVE TO COMPETE FOR THE GOVERNOR'S ATTENTION NOT ONLY WITH ALL OTHER TAX-EXEMPT FINANCINGS IN THE STATE BUT ALSO WITH ALL THE OTHER DUTIES AND OBLIGATIONS A GOVERNOR OR STATE LEGISLATURE MAY HAVE. IF THIS REQUIREMENT IS TO BE ONE OF SUBSTANCE RATHER THAN FORM, AT THE

STATE LEVEL, AND PARTICULARLY IN THE LARGER STATES, SUCH A PUBLIC HEARING AND APPROVAL REQUIREMENT WOULD CREATE SUCH A BOTTLENECK IT WOULD BE TANTAMOUNT TO DENYING HOSPITALS ACCESS TO TAX-EXEMPT FINANCING.

WHERE STATEWIDE BOND ISSUING AUTHORITIES EXIST, THEY ARE INSTRUMENTALITIES OF THE STATE GOVERNMENT. THEIR MEMBERS ARE USUALLY APPOINTED BY THE GOVERNOR. CHA SUBMITS THAT ACTION BY THESE STATEWIDE AUTHORITIES SHOULD SATISFY THE PUBLIC HEARING AND APPROVAL BY ELECTED OFFICIAL REQUIREMENT.

FINANCIAL CONTRIBUTION: UNDER THE ADMINISTRATION'S PROPOSAL, AFTER DECEMBER 31, 1985 UNITS OF STATE OR LOCAL GOVERNMENT WILL BE REQUIRED TO MAKE A FINANCIAL CONTRIBUTION EQUIVALENT TO 1% OF THE FACE VALUE OF THE BONDS TO EACH CAPITAL PROJECT FOR WHICH THEY ISSUE PRIVATE PURPOSE TAX-EXEMPT BONDS. THE CONTRIBUTION CAN TAKE THE FORM OF A CASH PAYMENT, TAX CREDIT OR ABATEMENT, OR PROVISION OF ADDITIONAL SERVICES. THE TREASURY DEPARTMENT, IN DOCUMENTS RELEASED FEBRUARY 26, 1982, DID INDICATE THAT THE GENERAL TAX EXEMPTIONS PROVIDED FOR EXEMPT ORGANIZATIONS UNDER STATE LAW COULD BE USED TO SATISFY THE CONTRIBUTION REQUIREMENT WITH RESPECT TO PROJECTS FOR EXEMPT ORGANIZATIONS.

THE RAMIFICATIONS OF THE IMPLEMENTATION OF THIS ASPECT OF THE ADMINISTRATION'S PROPOSAL COULD BE ABSOLUTELY DEVASTATING TO NOT-FOR-PROFIT HOSPITALS IF GENERAL TAX EXEMPTIONS UNDER STATE LAW ARE NOT ALLOWED TO SATISFY THE FINANCIAL CONTRIBUTION REQUIREMENT.

UNITS OF STATE, COUNTY AND MUNICIPAL GOVERNMENT AT THIS TIME AND FOR THE FORESEEABLE FUTURE ARE NOT IN THE FINANCIAL POSITION TO MAKE SUCH CONTRIBUTIONS. IN ADDITION, MANY STATE GOVERNMENTS, AND THEREFORE COUNTY AND LOCAL GOVERNMENTS, ARE CONSTITUTIONALLY PROHIBITED FROM MAKING CONTRIBUTIONS TO INSTITUTIONS WITH RELIGIOUS SPONSORS. FOR ALL INTENTS AND PURPOSES, TAX-EXEMPT FINANCING WILL CEASE TO BE AN AVENUE TO CAPITAL FOR NOT-FOR-PROFIT HEALTH FACILITIES EVEN THOUGH THESE HOSPITALS SERVE A PUBLIC PURPOSE.

IF TAX-EXEMPT BONDS CEASE TO BE AN AVENUE TO CAPITAL, HEALTH FACILITIES MUST USE TAXABLE BONDS. FOR MANY HOSPITALS, SUCH A PROPOSAL COULD THREATEN THEIR EXISTENCE.

- PRIVATE, NOT-FOR-PROFIT HOSPITALS IN THE INNER CITY WHICH HAVE A HIGH VOLUME OF MEDICARE, MEDICAID AND CHARITY PATIENTS PERFORM A PUBLIC SERVICE TO SUCH AN EXTENT THAT STATE, COUNTY AND/OR MUNICIPAL HOSPITALS COULD NOT PICK UP THAT LOAD IF THESE HOSPITALS WERE TO DISAPPEAR.
- HOSPITALS THAT SERVE A HIGH POPULATION OF MEDICARE, MEDICAID AND CHARITY PATIENTS TEND TO BE WEAKER HOSPITALS FINANCIALLY BECAUSE OF THE DISCOUNT ENJOYED BY THE MEDICARE AND MEDICAID PROGRAMS.
- BECAUSE OF THEIR WEAKER FINANCIAL CONDITION, THESE HOSPITALS WILL BE UNABLE TO COMPETE EFFECTIVELY FOR CAPITAL IN THE TAXABLE BOND MARKET.
- WITHOUT ACCESS TO CAPITAL, THEIR VERY EXISTENCE IS THREATENED.

FOR HOSPITALS THAT CAN COMPETE EFFECTIVELY IN THE TAXABLE BOND MARKET, SUCH A MOVE MEANS MORE EXPENSIVE HEALTH CARE:

- HOSPITALS THAT ARE ABLE TO FLOAT TAXABLE BONDS WILL HAVE TO PASS ON THE INCREASED COSTS OF TAXABLE FINANCING TO THE PATIENTS AND THEIR PAYORS.

- FOR EMPLOYERS AND EMPLOYEES, THIS MEANS SUBSTANTIAL INCREASES IN INSURANCE PREMIUMS AND THEREFORE INCREASES IN THE COST OF PRODUCTS THEY PRODUCE.

- FOR GOVERNMENT, THIS MEANS INCREASED PAYOUT FOR THE HEALTH INSURANCE PREMIUMS OF FEDERAL EMPLOYEES UNDER BOTH FHEP FOR CIVILIAN EMPLOYEES AND CHAMPUS FOR MILITARY EMPLOYEES, RETIREES AND THEIR DEPENDENTS. IT ALSO MEANS INCREASED PAYOUT IN THE FORM OF MEDICARE AND MEDICAID AND INCREASED COSTS FOR ALMOST EVERY GOOD OR SERVICE PURCHASED BY THE GOVERNMENT.

TAX-EXEMPT FINANCING FOR TAX-EXEMPT HEALTH CARE FACILITIES SHOULD REMAIN A REALITY

IN THIS SECTION OF OUR TESTIMONY WE WILL SEEK TO MAKE THE CASE THAT:

1. THERE ARE NO HEALTH POLICY CONSIDERATIONS WHICH WOULD PROVIDE SUFFICIENT JUSTIFICATION TO WARRANT RESTRICTING OR ELIMINATING ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HEALTH CARE FACILITIES.
2. THERE ARE A NUMBER OF HEALTH POLICY CONSIDERATIONS WHICH WOULD MORE THAN JUSTIFY PRESERVING ACCESS TO TAX-EXEMPT CAPITAL FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES.

...NO NEED TO RESTRICT OR ELIMINATE ACCESS TO TAX-EXEMPT FINANCING...:

THIS SECTION WILL ADDRESS TWO ARGUMENTS THAT HAVE BEEN OFFERED IN SUPPORT OF RESTRICTING OR ELIMINATING ACCESS TO TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HOSPITALS:

- OVERBEDDING

- TAX-EXEMPT FINANCING IS AN INEFFICIENT WAY TO SUBSIDIZE HOSPITAL CONSTRUCTION

OVERBEDDING: THE MAIN ARGUMENT IN THE OVERBEDDING AREA IS THAT THERE IS TOO MUCH HOSPITAL CAPACITY IN THE COUNTRY AS A WHOLE. THE MOST GRAPHIC ILLUSTRATION OF THIS POINT WAS MADE WITH RESPECT TO HOSPITAL BEDS WHEN THE BUREAU OF HEALTH PLANNING SET THE 4.0 BEDS PER 1,000 POPULATION. THERE MAY BE AREAS OR LOCALITIES THAT HAVE AN EXCESS OF HOSPITAL CAPACITY, BUT RESTRICTING OR ELIMINATING HOSPITAL ACCESS TO TAX-EXEMPT CAPITAL FINANCING TO CURE THAT PERCEIVED EVIL, IF IT DOES EXIST, IS AN OVERKILL SOLUTION TO THE PROBLEM.

TO BE SURE, SOME TAX-EXEMPT FINANCING MAY BE USED TO FINANCE NEW CONSTRUCTION OF HOSPITALS, BUT MUCH MORE HAS BEEN USED TO ADD NEW SERVICES, REFINANCE EXISTING DEBT, AND RENOVATE EXISTING FACILITIES. HOSPITALS REFINANCE THEIR DEBT FOR A VARIETY OF REASONS, ALL OF WHICH RESULT IN EITHER A STRONGER FINANCIAL POSITION FOR THE HOSPITAL OR A REDUCTION IN COSTS. HOSPITALS WILL CONTINUE TO NEED TO RENOVATE THEIR FACILITIES AS THEIR PHYSICIAL PLANTS BEGIN TO WEAR OUT AND FAIL BUILDING, LIFE SAFETY AND FIRE CODES.

ESTIMATES OF THE AMOUNT OF CAPITAL WHICH WILL BE NEEDED BY HOSPITALS IN THE 1980S RANGE FROM $130 BILLION TO $190 BILLION; AND AS IN THE PAST, A MAJOR PORTION, 70-80%, OF THAT CAPITAL WILL REFINANCE EXISTING DEBT OR RENOVATE EXISTING FACILITIES. THE APPROPRIATE QUESTION TO BE ASKED IS:

DOES THIS COUNTRY WANT TO RAISE THE COST OF HEALTH CARE IN THE '80S, '90S AND BEYOND BY THE INCREASED INTEREST NECESSARY ON TAXABLE FINANCING, JUST TO CURE AN OVERBEDDING PROBLEM WHICH MAY OR MAY NOT BE A REALITY?

TAX-EXEMPT FINANCING IS AN INEFFICIENT WAY TO SUBSIDIZE HOSPITAL CONSTRUCTION: ONE OF THE ARGUMENTS IN THIS AREA IS THAT MUCH OF THE SUBSIDY ASSOCIATED WITH TAX-EXEMPT FINANCING, AS MUCH AS ONE-THIRD, GOES TO BOND HOLDERS, UNDERWRITERS AND BOND COUNSEL.

PROPONENTS OF THE INEFFICIENCY ARGUMENT SUGGEST THAT WITH DIRECT SUBSIDIES, LIKE A HILL-BURTON PROGRAM, 100% OF THE SUBSIDY WOULD GO TO THE INSTITUTION. HOWEVER, DIRECT SUBSIDIES AT THE NATIONAL LEVEL WOULD REQUIRE BOTH A SIZEABLE BUDGET AND A SIZEABLE FEDERAL BUREAUCRACY TO IMPLEMENT THE PROGRAM. SUCH AN EFFORT WOULD BE INCONSISTENT WITH THE REAGAN ADMINISTRATION'S OBJECTIVE OF REDUCING THE SIZE OF GOVERNMENT AND COULD BE MORE EXPENSIVE THAN THE PRESENT TAX-EXEMPT FINANCING MECHANISM.

...JUSTIFICATION FOR PRESERVING ACCESS TO TAX-EXEMPT FINANCING...

FOR A NUMBER OF REASONS, TAX-EXEMPT FINANCING IS AND SHOULD REMAIN AN INTEGRAL PART OF THE FINANCING OF NOT-FOR-PROFIT HEALTH CARE FACILITIES. THESE REASONS REVOLVE AROUND THE FOLLOWING CONSIDERATIONS:

- PUBLIC PURPOSE OF NOT-FOR-PROFIT HOSPITALS;
- MAGNITUDE OF THE NEED FOR CAPITAL;
- CONSEQUENCES OF SEEKING TAXABLE FINANCING;
- PROBLEMS ASSOCIATED WITH CURRENT GOVERNMENT REIMBURSEMENT POLICY;

- POTENTIAL DISADVANTAGE OF NOT-FOR-PROFIT HOSPITALS VIS-A-VIS THEIR FOR-PROFIT COUNTERPARTS.

PUBLIC PURPOSE OF NOT-FOR-PROFIT HOSPITALS: NOT-FOR-PROFIT HOSPITALS UNQUESTIONABLY SERVE A PUBLIC PURPOSE, AN ESSENTIAL PUBLIC PURPOSE AS ACUTE CARE HEALTH FACILITIES ESTABLISHED BY UNITS OF STATE, COUNTY AND CITY GOVERNMENTS. THEY SERVE THE GENERAL PUBLIC AS WELL AS PATIENTS WHO ARE BENEFICIARIES OF GOVERNMENT PROGRAMS LIKE MEDICARE AND MEDICAID AND THE INDIGENT AND MEDICALLY INDIGENT IN THE COMMUNITY.

IN ALMOST EVERY LARGE INNER CITY IN THE COUNTRY THERE ARE NOT-FOR-PROFIT HOSPITALS WHOSE PATIENT LOADS ARE PRIMARILY MEDICARE, MEDICAID, AND THE POOR. THESE HOSPITALS ARE, IN MOST INSTANCES, RELATIVELY WEAK FINANCIALLY BOTH BECAUSE OF THE INADEQUACIES OF THE MEDICARE AND MEDICAID REIMBURSEMENT MECHANISM AND BECAUSE OF THEIR HIGH CHARITY LOAD. IF WELL MANAGED, THESE HOSPITALS CURRENTLY RECEIVE BBB RATINGS ON THEIR TAX-EXEMPT BONDS.

FREQUENTLY THESE HOSPITALS ARE OLDER FACILITIES, BUILT EARLY IN THIS CENTURY AND IN THE NEAR FUTURE WILL BE AMONG THE FIRST TO ATTEMPT TO RAISE CAPITAL TO RENOVATE OR REPLACE THEIR WORN OUT PHYSICAL PLANTS. IF TAX-EXEMPT FINANCING IS RESTRICTED OR ELIMINATED AS A RESULT OF IMPLEMENTING THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL, MANY OF THESE HOSPITALS WILL BE ELIMINATED FROM THE TAXABLE BOND MARKET. BECAUSE OF THEIR RELATIVELY WEAK FINANCIAL CONDITIONS, BOND RATING AGENCIES ARE LIKELY TO GIVE THESE HOSPITALS' TAXABLE BONDS A BB RATING, A RATING WHICH IS NOT HIGHLY SALABLE.

IF THESE HOSPITALS FAIL BECAUSE THEIR WORN OUT PHYSICAL PLANTS CANNOT PASS BUILDING, FIRE AND LIFE SAFETY CODES AND BECAUSE THEY CANNOT OBTAIN THE CAPITAL NECESSARY TO RENOVATE OR REPLACE THEIR PHYSICAL PLANT, WHO WILL PICK UP THEIR PATIENT LOAD? THERE ARE NOT ENOUGH PUBLIC HOSPITALS TO FULFILL SUCH AN EXPANDED NEED.

NOT-FOR-PROFIT HOSPITALS ARE NOT MERELY PUBLIC PURPOSE, AS A PARK IS PUBLIC PURPOSE. THEY ARE ESSENTIAL PUBLIC PURPOSE ENTITIES.

HOSPITAL CAPITAL NEEDS IN 1980S - $130-190 BILLION. CONSEQUENCES OF SEEKING TAXABLE FINANCING: ESTIMATES OF THE AMOUNTS OF CAPITAL WHICH WILL BE NEEDED BY HOSPITALS IN THE 1980S RANGE FROM $130 BILLION TO $190 BILLION. IF TAX-EXEMPT FINANCING IS RESTRICTED OR ELIMINATED AS A RESULT OF THE ADMINISTRATION'S PROPOSAL, FINANCIALLY SOUND HOSPITALS WILL RAISE CAPITAL THROUGH TAXABLE BONDS. INTEREST RATES ON TAXABLE AND TAX-EXEMPT BONDS HAVE NARROWED IN RECENT YEARS BUT THERE IS A DIFFERENCE. INTEREST ON TAXABLE BONDS IS GENERALLY 3-5% HIGHER THAN INTEREST ON TAX-EXEMPT BONDS. IF HOSPITALS ARE FORCED INTO THE TAXABLE BOND MARKET, THEY ARE LIKELY TO HAVE TO PAY ADDITIONAL INTEREST EQUAL TO 50% OF THE PRINCIPAL.

A SEARCH FOR TAXABLE FINANCING ALSO PRESENTS OTHER PROBLEMS FOR HOSPITALS. BY AND LARGE THE LENGTH OF A TAXABLE FINANCING IS CONSIDERABLY SHORTER THAN THE LIFE OF THE ASSET AS RECOGNIZED BY MEDICARE. FOR INSTANCE, IF A HOSPITAL USES TAXABLE FINANCING

TO REPLACE ITS PHYSICAL PLANT, IT MAY HAVE TO PAY OFF THE LOAN OVER A TEN OR FIFTEEN YEAR PERIOD. HOWEVER, MEDICARE WILL REQUIRE THE LIFE OF THE ASSET TO BE 20 OR MORE YEARS AND REIMBURSE DEPRECIATION OVER THE 20-YEAR PERIOD. HAVING TO RETIRE THE DEBT FASTER THAN THE DEPRECIATION SCHEDULE RECOGNIZED BY MEDICARE WILL ONLY ERODE FURTHER THE FINANCIAL VIABILITY OF HOSPITALS.

FURTHERMORE, IF HOSPITALS ARE FORCED INTO THE TAXABLE BOND MARKET, THAT MEANS HIGHER INTEREST PAYMENTS FOR HOSPITALS AND A HIGHER COST OF MEDICAL CARE. HOSPITALS THAT GO FOR TAXABLE FINANCING WILL HAVE TO PASS THIS INCREASED COST TO INSURERS. INSURERS WILL IN TURN PASS THIS ALONG TO EMPLOYERS WHO PAY FOR EMPLOYEE HEALTH BENEFITS. THE COST OF PRODUCTION OF GOODS AND SERVICES WILL IN TURN INCREASE GENERALLY. THIS WILL RESULT IN HIGHER PRICES FOR GOVERNMENT AND THE PUBLIC IN GENERAL AS THEY PURCHASE GOODS AND SERVICES FROM THE PRIVATE SECTOR.

ABILITY OF NOT-FOR-PROFIT HOSPITALS TO RAISE CAPITAL IS IMPAIRED BY FEDERAL TAX AND MEDICARE/MEDICAID REIMBURSEMENT POLICY: PRIVATE, NOT-FOR-PROFIT HOSPITALS CANNOT RAISE EQUITY CAPITAL (I.E., ISSUE STOCK). TO RAISE CAPITAL, NOT-FOR-PROFIT HOSPITALS MUST RELY ON CHARITABLE CONTRIBUTIONS, EARNINGS ACCUMULATION OR DEBT FINANCING.

- CHARITABLE GIVING OR PHILANTHROPY HAS BEEN DECLINING AS A SOURCE OF CAPITAL FOR THE POPULATION OF HOSPITALS AS A WHOLE. AT THE CLOSE OF THE 1970S, PHILANTHROPY ACCOUNTED FOR APPROXIMATELY 2% OF THE TOTAL SOURCES OF HOSPITAL CAPITAL. IN ADDITION, CHARITABLE CONTRIBUTIONS, INCLUDING THOSE MADE TO NOT-FOR-PROFIT HOSPITALS, ARE PREDICTED TO DECLINE AS A RESULT OF THE DIMINISHED

INCENTIVE TO MAKE SUCH CONTRIBUTIONS WITH THE PHASE-IN OF THE TAX RATE REDUCTIONS ENACTED IN 1981.

- EARNINGS ACCUMULATION OCCURS WHEN REVENUES EXCEED THE COSTS OF DELIVERING MEDICAL CARE. MEDICARE AND MEDICAID CREATE A SERIOUS PROBLEM IN THIS AREA. ALTHOUGH MEDICARE IS ALLEGED TO PAY FOR THE "REASONABLE COST" OF DELIVERING MEDICAL CARE IN INSTITUTIONAL SETTINGS, THERE ARE SEVERAL COSTS THAT ARE NOT RECOGNIZED BY MEDICARE AS ALLOWABLE. SUCH COSTS WOULD INCLUDE RETURN ON EQUITY FOR NOT-FOR-PROFIT FACILITIES. IT IS GENERALLY BELIEVED THAT THE SHORTFALL IN MEDICARE REIMBURSEMENT DUE TO NON-RECOGNITION OF SUCH COSTS IS 15-20%. UNDER THE MEDICAID PROGRAM THE SHORTFALL IS ESTIMATED TO BE AS MUCH AS 30% IN SOME INSTANCES. WHEN THE MEDICARE/MEDICAID REIMBURSEMENT PROVISIONS OF THE OMNIBUS RECONCILIATION ACTS OF 1980 AND 1981 ARE IMPLEMENTED, THE SHORTFALLS WILL GROW EVEN LARGER.

  MEDICARE AND MEDICAID DO REIMBURSE FOR DEPRECIATION BASED ON THE HISTORICAL COST OF THE ASSET. HOWEVER, IF A HOSPITAL FUNDS ITS DEPRECIATION, THE DOLLAR AMOUNT IN THE FUNDED DEPRECIATION ACCOUNT AT THE END OF THE DEPRECIATION SCHEDULE IS THE ORIGINAL PRICE OF THE ASSET AT PURCHASE. INFLATION IN THE INTERVENING YEARS WILL CAUSE THE REPLACEMENT COST OF THE ASSET TO BE SUBSTANTIALLY MORE THAN THE ACCUMULATED DEPRECIATION.

  NOT ONLY DO MEDICARE AND MEDICAID NOT CONTRIBUTE TO EARNINGS ACCUMULATION BUT THEIR REIMBURSEMENT POLICIES ALSO TEND TO WEAKEN HOSPITALS FINANCIALLY. THE MORE MEDICARE AND MEDICAID PATIENTS WHICH A HOSPITAL TREATS, THE MORE IT TENDS TO ERODE ITS CAPITAL BASE.

THIS PROPOSAL COULD HAVE A MAJOR IMPACT ON THE VIABILITY OF

NOT-FOR-PROFIT HOSPITALS VIS-A-VIS THEIR INVESTOR-OWNED, FOR-PROFIT HOSPITAL COUNTERPARTS: SINCE THE ADVENT OF MEDICARE AND MEDICAID, THE INVESTOR-OWNED HOSPITAL HAS BECOME A LARGE AND GROWING PART OF THE TOTAL HOSPITAL SECTOR. THESE INVESTOR-OWNED HOSPITALS COMPETE WITH NOT-FOR-PROFIT HOSPITALS FOR DOCTORS, PATIENTS AND CAPITAL. BY RAISING THIS POINT CHA DOES NOT MEAN TO SPEAK AGAINST FOR-PROFIT HOSPITALS OR THE COMPETITION THEY BRING TO THE HEALTH CARE SECTOR. WE DO MEAN TO ~~SAY,~~ HOWEVER, THAT FEDERAL POLICIES THAT WOULD AFFECT EITHER THE FOR-PROFIT OR THE NOT-FOR-PROFIT FACILITY, DIRECTLY OR INDIRECTLY, SHOULD NOT BE ADVOCATED OR IMPLEMENTED WITHOUT TAKING INTO CONSIDERATION THE EFFECT OF THE PROPOSAL ON THE ABILITY OF EACH SECTOR OF THE INDUSTRY TO COMPETE WITH THE OTHER. THAT IS, THE GOVERNMENT SHOULD PROVIDE NEITHER ADVANTAGE NOR DISADVANTAGE TO EITHER SECTOR AS A RESULT OF ITS POLICIES.

WITH RESPECT TO ACCESS TO CAPITAL THE NOT-FOR-PROFIT HOSPITAL IS ALREADY WIDELY VIEWED AS BEING AT A SERIOUS DISADVANTAGE TO ITS INVESTOR-OWNED COUNTERPART. WHILE REDUCED PHILANTHROPY AND GOVERNMENT REIMBURSEMENT POLICIES JEOPARDIZE THE FINANCIAL STRENGTH AND THUS, THE INVESTMENT APPEAL, OF NOT-FOR-PROFIT HOSPITALS, THE FOR-PROFIT HOSPITAL INDUSTRY SIMPLY ISSUES MORE STOCK IN WHAT IS, AT THE PRESENT TIME, A STRONG GROWTH SECTOR OF THE MARKET. TWO FACETS OF THIS ADMINISTRATION'S PROPOSAL WOULD ADD SIGNIFICANTLY TO THE PRESENT DISADVANTAGE OF NOT-FOR-PROFIT FACILITIES.

FIRST OF ALL, THE PUBLIC HEARING AND APPROVAL PROCESS OF TAX-EXEMPT FINANCING IS A PROCESS TO WHICH THE FOR-PROFIT HOSPITAL WOULD NOT BE SUBJECT SINCE IT DOES NOT ORDINARILY SEEK SUCH FINANCING. IN ADDITION, SUCH A PROCESS WOULD CREATE A BOTTLENECK AT THE GOVERNOR'S OFFICE IN MANY STATES AND IN SO DOING, ADD TO THE COST OF THE PROJECT BY DELAYING CONSTRUCTION.

THE FINANCIAL CONTRIBUTION REQUIREMENT, IF IMPLEMENTED WITHOUT SPECIAL CONSIDERATION FOR TAX-EXEMPT ORGANIZATIONS, WOULD ELIMINATE ALMOST ALL ACCESS TO TAX-EXEMPT FINANCING, PARTICULARLY FOR THOSE HOSPITALS THAT SERVE HIGH PROPORTIONS OF MEDICARE/MEDICAID AND CHARITY PATIENTS. SUCH A PROPOSAL WOULD SIMPLY ELIMINATE THEIR ACCESS TO CAPITAL.

SUMMARY AND RECOMMENDATION

IN SUM, CHA FINDS THAT THE ADMINISTRATION'S ARGUMENT THAT TAX-EXEMPT BONDS ISSUED FOR PRIVATE PURPOSE

- CAUSE HIGHER INTEREST RATES FOR STATE AND LOCAL FINANCINGS, AND
- CAUSE REVENUE LOSS TO THE FEDERAL TREASURY

DOES NOT STAND UP WHEN VIEWED IN THE CONTEXT OF TAX-EXEMPT CAPITAL FINANCING FOR NOT-FOR-PROFIT HOSPITALS.

FURTHERMORE, THERE APPEARS TO BE NO HEALTH POLICY CONSIDERATION WHICH WOULD PROVIDE SUFFICIENT JUSTIFICATION TO WARRANT RESTRICTING ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HOSPITALS. ON THE CONTRARY, THERE ARE SEVERAL HEALTH POLICY CONSIDERATIONS WHICH WOULD MORE THAN JUSTIFY PRESERVING

ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HEALTH CARE FACILITIES, FACILITIES WHICH SERVE AN ESSENTIAL PUBLIC PURPOSE.

CHA RECOMMENDS THAT IF THE CONGRESS FEELS COMPELLED TO MODIFY THE STATUTE WITH RESPECT TO TAX-EXEMPT FINANCING FOR PRIVATE PURPOSES THAT SUCH MODIFICATIONS NOT APPLY TO EXEMPT ORGANIZATIONS (NOT-FOR-PROFIT HOSPITALS) AS DESCRIBED IN 103(B)(3) OF THE STATUTE.

[illegible]

ASSOCIATED
HOSPITAL
SYSTEMS

March 26, 1982

Fairview Community Hospitals
Minneapolis, Minnesota

Greenville Hospital System
Greenville, South Carolina

Health Central, Inc.
Minneapolis, Minnesota

Holy Cross Health System
South Bend, Indiana

Intermountain Health Care, Inc.
Salt Lake City, Utah

Lutheran Hospital Society
of Southern California
Los Angeles, California

Metropolitan Hospitals, Inc.
Portland, Oregon

Samaritan Health Services
Phoenix, Arizona

Sisters of Mercy Health Corp.
Farmington Hills, Michigan

Southwest Community Health Services
Albuquerque, New Mexico

The Honorable Robert J. Dole
Chairman
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Associated Hospital Systems strongly objects to the Administration's proposals to impose restrictions on the tax exemption of bonds for tax exempt organizations, especially non-profit hospitals. It is our hope that you will include this statement in the hearing record for the hearings of the Committee scheduled for March 17 through 19. We appreciate the opportunity to submit these comments.

ASSOCIATED HOSPITAL SYSTEMS (AHS)

AHS is comprised of ten systems of hospitals that are exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code. The systems, as indicated on our stationery, cover a wide geographic region of some 22 states; owned, leased or managed over 150 hospitals with approximately 30,000 acute care beds. Our member systems pride themselves on the public service they provide in their many communities as voluntary, non-profit organizations. To provide this service requires some $2 billion annually to support the related costs.

ADMINISTRATION CONCEPT

It is our understanding that the Administration proposes to impose a variety of new restrictions on use of tax-exempt bonds. Four of these proposed restrictions adversely affect non-profit hospitals.

1) The highest elected official or legislative body, for example, the Mayor or City Council, of the governmental unit issuing the bonds and in which the facility is located, must approve the bonds after a public hearing. Alternatively, the public approval requirement could be met by a voter referendum on the bonds to be issued for the particular facility.

2) In the case of bonds issued after December 31, 1985, the governmental unit must make a financial contribution or commitment

to the facility financed with tax-exempt bonds. The contribution could take the form of a cash payment, tax credit or abatement provision of additional services, or payment of the bond issuance expenses with a value on the date the bonds are issued equal to 1% of the face amount of the bonds. Alternatively, the issuing governmental unit can satisfy the commitment requirement by insuring or guaranteeing the bonds or by designating the bonds as general obligations of the state or local government. As is discussed below, the application of this requirement to non-profit hospitals--which state and local governments already exempt from taxation--is ambiguous in the Treasury Department's description of the Administration's proposal.

3) Each bond must be registered, not bearer, form.

4) Restrictions on the investment yield from the use of the proceeds of the obligations are extended to reserve funds and funds held during the temporary construction period. Bond costs may not be taken into account in determining the yield for purposes of the arbitrage limitations.

Other restrictions would be applied to "small issue" industrial revenue bonds issued under Section 103(b)(6) of the Internal Revenue Code. These restrictions would include limiting the availability of IDB's to small businesses and requiring that entities choose between the tax exemption and use of the ACRS provisions of the Economic Recovery Tax Act. These provisions do not apply to bonds issued by tax-exempt organizations.

The proposed restrictions on non-profit hospital bonds appear to be based on several premises:

- Bonds issued for non-profit hospitals are utilized for "private" activities.
- The Treasury will gain substantial revenue through limiting the current exemption for interest earned on bonds issued for non-profit hospitals.

Implicit in the Treasury's discussion is the further premise that non-profit hospitals have access to other forms of capital to finance their needed renovations and other projects.

We would like to discuss these premises in some detail.

TAX-EXEMPT HOSPITALS SERVE A "PUBLIC" PURPOSE

Insofar as the I.R.S. is concerned, hospitals exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1954, as amended, are clearly serving a "public rather than a private interest." (I.R.S. Reg. 1.501 (c)(3)-(1)(d)(ii)). Thus, characterizing hospital bonds as being used for "private"activities is inconsistent with the basis on which the I.R.S. grants tax-exempt status to such hospitals. The exempt purpose of such non-profit hospitals is further exemplified by the provision of free services to many individuals, as was a requirement for many of these hospitals in order to receive grants under the so-called Hill-Burton program.

CLAIMS OF ABUSE ARE UNSUBSTANTIATED AND IGNORE OTHER CHECKS AND BALANCES IN THE SYSTEM

The Treasury Department's February 26, 1982, explanation does not allege that tax-exempt bonds have contributed to construction of unneeded hospitals, but this allegation has been made in the past. This allegation ignores not only the existence of other regulatory checks, but also ignores the workings of the financial marketplace. Hospitals seeking to secure debt through the issuance of tax-exempt bonds must compete on the open market for the investor dollar. The institutional or individual investor must choose between numerous investment options. The fact that many such investors have historically chosen to invest in a hospital bond reflects not only a recognition of the prudence of issuing such debt (in their opinion), but also their willingness to support such public purposes.

Numerous regulatory checks also exist in the system suggesting that, if unneeded hospitals have been financed through tax-exempt bonds, the existence of such an exemption can hardly be held as a casual factor. Zoning laws, state certificate of need and licensure laws, state rate review programs, and other state and local initiatives provide that a myriad of approaches must be obtained prior to ever issuing tax-exempt bonds for the purpose of financing such projects. Further, the current process of issuing such bonds is subject to continuous public scrutiny. We remain unclear that abuses in the issuance of such bonds have occurred.

It is unclear that the growing use of tax-exempt financing by hospitals has contributed to any growth in capital expenditures, let alone construction of unneeded hospitals. In fact, there is no demonstrated relationship. During the period 1973-1979, when the portion of hospital construction financed with tax-exempt bonds rose from 21% to 49%, private hospital construction spending was relatively stable rising from $3.05 billion in 1973 to $4.3 billion in 1979 (our most recent data). When inflation over the period is considered, the real value of hospital construction actually dropped to $2.6 billion in 1979. Most of this tax-exempt financing is used for renovation, modernization, and replacement of existing facilities and refinancing of existing debt, not construction of new beds.

IMPOSING RESTRICTIONS ON NEW HOSPITAL BONDS WILL NOT SUBSTANTIALLY INCREASE FEDERAL REVENUE

The Treasury Department does not and cannot claim that it's proposed restrictions would have much, if any, short term impact in increasing federal revenue and in reducing burgeoning deficits. In fact, for Fiscal Year 1983, the Treasury Department acknowledges that it's proposal would result in a net loss in revenue of $200 million. The Administration has released no estimates on the revenue it expects to gain in Fiscal 1984 or 1985 from that part of its proposal restricting the tax-exemption for non-profit hospital bonds [1] but the Fiscal 1982 Carter Administration budget estimated that the increased revenue in Fiscal 1981 and 1982 from restricting the exemption would be only $35 million and $135 million, respectively (FY 1982 Budget Special Analysis G, page 231).

These estimates of revenue gain do not take into account the offsetting increases that would occur in federal outlays under the Medicare and Medicaid programs due to the increased cost of capital that would result from taxable debt. AHS currently has outstanding approximately $900 million in combined long-term tax-exempt debt. With a 33.2% rate of Medicare and 7.2% rate of Medicaid utilization, this means that for every additional dollar that AHS must pay in interest rates, Federal government outlays for reimbursement to AHS alone will increase by approximately .37¢. Assuming a 3 percentage point spread between interest rates for tax-exempt and conventional financing, the annual Federal reimbursement to AHS hospitals on existing debt would be approximately $10,000,000 greater. This increased reimbursement to AHS along would offset more than one-fourth of all the revenue that the Treasury Department apparently projects it would gain in Fiscal 1984 by restricting the exemption for all non-profit hospital bonds.

Rather than focus on the limited, or even negative, revenue impact of restricting the exemption for hospital bonds, the Treasury Department and others have emphasized claims that the estimated revenue loss from the tax-exemption for non-profit hospital bonds is $845 million for Fiscal 1983. This claim, however, is misleading and irrelevent as an indication of the revenue that would be gained should the exemption be restricted. The reason for the vast discrepancy between the revenue loss and revenue gain figures is that the Administration proposes only to apply its restrictions to the exemption for new hospital bonds, not retroactively to the exemption granted in the past for all outstanding hospital bonds. To retroactively rescind the exemption for existing bonds would raise serious constitutional questions. This means that far less revenue is gained from the proposed restrictions on new bonds than supposedly is being lost from the exemption on both new and old bonds.

HOSPITALS RELIANCE ON TAX-EXEMPT DEBT IS SIGNIFICANT

It is particularly discouraging to us that the Administration might consider trying to cut back on federal health expenditures by cutting off the life blood of hospital debt--tax-exempt bonds. As early as 1977, tax-exempt bonds accounted for the majority of the dollars used for all hospital renovation, modernization and construction. Hospitals have turned to tax-exempt bonds to replace other sources of financing which have dried up, such as government programs and philanthropy. For the Congress to restrict the exemption would have a truly devastating impact on non-profit hospitals.

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[1] The Administration projects a revenue gain of $300 million in Fiscal 1984 and $1.1 billion in Fiscal 1985, but these figures are for restrictions on all tax-exempt revenue bonds, not just those of non-profit hospitals. Currently, tax-exempt bonds for non-profit hospitals constitute approximately 11% of the total volume for tax-exempt revenue bonds, indicating that the Administration expects its proposed restrictions on hospital bonds to increase Federal revenues by only $33 million in Fiscal 1984 and $121 million in Fiscal 1985. These are the same estimates given in President Carter's Fiscal 1982 budget for Fiscal 1981 and 1982.

FINANCIAL CONSTRIBUTION REQUIREMENT

On its face, the Administration does not propose that the tax-exemption for non-profit hospitals be completely eliminated. Depending on how the proposal is interpreted, however, it could well have this effect. For example, the Administration proposes that tax-exempt bonds be available only where the governmental unit makes a "financial contribution or commitment to the project" in an amount equal to 1% of the face amount of the bond. (General and Technical Explanation at page 28.) This contribution must be "specifically earmarked for the facility or project," meaning that "general tax reductions or regular services provided to all facilities are not counted for this purpose." (Id. at 28-29.) Were this requirement applied to non-profit hospital bonds, such bonds would not be available. The Constitution in most states would prohibit such a contribution and in other states, facing mammoth federal aid cutbacks, no funds would be available to make such a contribution.

The Administration proposal does states that "general tax exemptions provided for exempt organizations under State law could be used to satisfy the contribution requirement with respect to projects for exempt organizations." (Id.) As stated above, the meaning of this qualification is ambiguous. If it means that State and local governments would not be required to make a financial contribution specifically earmarked to a project of a non-profit hospital, it would mitigate the impact of the financial contribution requirement. Adoption of such a qualification is warranted for tax-exempt organizations because State and local governments already make an indirect financial contribution to such organizations by granting them an exemption from State and local taxes. To require that such governmental units make an additional contribution to each specific project is inequitable and unreasonable. Given the tax-exempt status of non-profit hospitals, a State or local government cannot further abate the State or local taxes of the hospital. This means that any additional financial contribution to a specific project would likely have to take the form of a direct equity contribution to the project, the form of contribution that specifically is prohibited in many State constitutions.

CONCLUDING REMARKS

The key issue facing hospitals in the 1980s is capital formation. Hospitals are consuming their own capital largely due to current federal reimbursement policies that do not cover full cost of operations and ignore the requirement to reimburse non-profit hospitals for a return on equity. The result, over time, is that hospitals increasingly are assuming greater levels of debt to replace existing assets. As this statement demonstrates, restricting the tax exemptions for non-profit hospital bonds would severely exacerbate the financial strain already felt by non-profit hospitals, impair their ability to renovate and modernize existing facilities, and prevent expansion in those areas where patient needs warrant construction of additional facilities.

In the opinion of Associated Hospital Systems, it is imperative that not-for-profit hospitals continue to have access to tax-exempt bonds. To deny such access may well result in a significant deterioration in health services to this nation's public.

Please do not support the Administration's proposals regarding tax-exempt hospital bonds. We very much appreciate the opportunity to submit this statement.

Respectfully submitted,

Edward J. Connors

Edward J. Connors
Chairman, AHS

/jkp

cc: Members of Senate Finance Committee

Insert to Record ;

Adventist Health System - West
1545 North Verdugo Road, Box 2054, Glendale, California 91209
(213) 956-1900

March 18, 1982

The Honorable Robert J. Dole
Chairman, Senate Finance Committee
2227 Dirksen Building
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of Adventist Health System-West, I appreciate your invitation to submit a statement to be included in the hearing record for the Committee's March 17 hearing on tax-exempt revenue bonds.

I serve as President of Adventist Health System-West, a multi-hospital system based in Glendale, California. Adventist Health System-West is a non-profit, tax-exempt organization that has seventeen owned and managed hospitals in the states of California, Oregon, Washington, Idaho, Hawaii and Arizona with a total of 2,700 acute care beds and a gross revenue of approximately $400,000,000.

On February 26, 1982, the Treasury Department announced that the Reagan Administration would propose major restrictions on the current tax-exemption for bonds for tax-exempt organizations, including non-profit hospitals. Adventist Health System-West and each of its seventeen hospitals strongly oppose this proposal for the reasons outlined in this statement.

The Administration's proposal is based on the assertion that tax-exempt bonds issued for non-profit hospitals are utilized for "private activities." The proposal makes no distinctions among tax-exempt bonds for commercial and manufacturing enterprises, proprietary and non-profit hospitals, and non-profit education institutions. While the Administration's assertion may have some validity with respect to other users of tax-exempt financing, it is not accurate with respect to bonds of non-profit hospitals. The regulations of the Internal Revenue Service explicitly state that non-profit hospitals are entitled to tax-exempt status only if they serve a "public rather than a private interest." I.R.S. Regulations 1.501(c)(3) - (1)(d)(1)(ii). For the Treasury Department to characterize hospital bonds as bonds for "private" activities, therefore, is inconsistent with the premise upon which I.R.S. relies in granting tax-exempt status to non-profit hospitals. As you can appreciate, non-profit hospitals must view this inconsistency potentially as having troubling and indeterminate long-term implications.

Contrary to the assertion of the Treasury Department, tax-exempt, non-profit hospitals serve a public purpose in the same sense as do public hospitals. As a matter of policy, as required in many states and as a condition for receipt of grants under the Hill-Burton program, non-profit hospitals provide free health care to indigents. Adventist Health System-West hospitals provided $2,916,386 in charity care and another $5,612,389 in bad debts written off. If the ability of non-profit hospitals to meet their capital requirements is impaired, public hospitals will be forced to increase their share of responsibility for providing medical care. For these reasons it is simply inaccurate for the Treasury Department to characterize non-profit hospital bonds as bonds for "private activities."

To justify its proposed restrictions on non-profit hospital bonds the Administration cites no abuse of the exemption. In the past there have been allegations that the existence of the exemption leads to construction of unneeded hospitals. This allegatin, however, ignores the fact that in almost all cases non-profit hospitals must obtain a certificate-of-need before they may proceed with a construction project. No prudent investor would buy bonds for a hospital for which a certificate-of-need had not been obtained.

Nationally, when adjusted for inflation, hospital construction actually declined by 35% between 1971 and 1979.

Furthermore, this allegation fails to recognize that most tax-exempt financing is for renovation of existing facilities and refinancing of existing debt, not construction of new facilities.

Such renovation and refinancing may reduce hospital and patient costs. One of Adventist Health System-West's hospitals refinanced taxable debt to tax-exempt and realized a savings in excess of $500,000 annually. Restricting the exemption therefore, is not needed to remedy any documented abuse.

The Treasury Department cannot claim that its proposed restrictions would result in much, if any, short-term increase in Federal revenue and reduction in the burgeoning deficit. In fact, for Fiscal 1983 the Treasury Department acknowledges that its proposal will result in a net loss in revenue of $200 million. The Department has released no estimates on the revenue impact of that part of its proposal restricting the tax-exemption for non-profit hospital bonds but the Fiscal 1982 Carter Administration budget estimated that the increased revenue in Fiscal 1981 and 1982 from restricting the exemption would be only $35 million and $135 million, respectively. Fiscal Year 1982 Budget, Special Analysis G at page 231.

These estimates do not take into account the automatic increases in Federal outlays under the Medicare and Medicaid programs due to increased claims for reimbursements Fiscal Year 1982 Budget at page 81. AHS-West currently has outstanding approximately $31,000,000 in long-term, tax-exempt debt. With a 48% rate of Medicare and 17% Medicaid utilization, this means that for every additional dollar AHS-West must pay in interest rates Federal government outlays for reimbursement to AHS-West will increase by approximately 65 cents. Assuming a three percentage point spread between the interest rates for tax-exempt and conventional financing, the added Federal reimbursement to AHS-West alone on existing debt would be approximately $2.28 million per year. This amount of increased Federal expenditures for AHS-West alone then is more than six percent of the Treasury Department's estimates for increased Federal revenue in Fiscal 1981.

AHS-West has plans to seek approval within the next year for $78,000,000 of tax-exempt bonds. This financing will fund projects at five member hospitals of the AHS-West system, including the following projects: (1) remodeling of physical therapy, central supply and laboratory facilities; (2) relocation and expansion of acute psychiatric service (with a equivalent reduction in medical surgical beds); (3) remodeling of twelve medical surgical beds; and (4) renovation of current emergency medical, clinical lab, radiology, nuclear medicine, pharmacy, respiratory therapy, and nursery facilities. Were AHS-West forced to raise these funds through conventional financing, it will face an increase in interest payments of approximately $4 million per year and $120 million over the term of the bond. This additional payment is approximately 1% of the yearly gross revenues received by AHS-West and would necessitate raising patient costs by $7.00 per day over the thirty year term of the bond. Of this amount the Federal and State governments would reimburse AHS-West approximately $4.55 per patient per day and $78,000,000 over the term of the bond.

These estimates assume that conventional financing would be available to AHs-West to borrow $78 million. In order to obtain conventional financing, however, it is likely that AHS-West would be required by lenders to make a 20-40% equity contribution to the financing of such projects. This contribution could only by generated by increased rates, charitable contributions, funded depreciation or other internal sources. For AHS-W a 30% equity contribution to these projects would be approximately $22,400,000, a staggering figure. If this contribution was generated solely by increasing rates for non-Medicare patients for one year, the increase would be approximately $85.00 per patient per day. Were the Federal government to reimburse the hospital for that portion of the equity contribution attributable to Medicare patients, the increase in rates for all patients would be nearly $40.00 per patient per day. This figure does not include the costs of the higher interest rates that AHS-West would have to pay to obtain such conventional financing.

In order for non-profit hospitals effectively to compete for conventional financing at market rates, they would need to be reimbursed for a reasonable return-on-equity. Without a return-on-equity non-profit hospitals would be forced to pay premium rates for conventional financing. If this return-on-equity was set at 18%, the rate currently available to proprietary hospitals, the additional Federal reimbursement to AHS-West would be approximately $18,000,000 per year.

The devastating financial impact from loss of the tax exemption for hospital bonds is exacerbated by the fact that current Medicare and Medicaid reimbursements fails adequately to compensate AHs-West for its costs. The shortfall currently is approximately 16%, meaning that AHS-West must attempt to shift this cost to its private pay patients. Given the fact that AHS-West has a higher than average Medicare and Medicaid patient load, its ability to shift these costs to other patients has reached the breaking point. For the Federal government now to restrict the tax exemption for the bonds that AHS-West must issue to removate its existing facilities will place an intollerable financial burden on AHS-West.

On its face the Administration does not propose that the tax-exemption for non-profit hospitals be completely eliminated. Depending on how the proposal is interpreted, however, it could well have this effect. For example, the Administration proposes that tax-exempt bonds be available only where the governmental unit make a "financial contribution or commitment to the project" in an amount equal to one percent of the face amount of the bond. General and Technical Explanation at page 28. This contribution must be "specifically earmarked for the facility or project," meaning that "(g)eneral tax reductions or regular services provided to all facilities are not counted for this purpose." Id. at 28-29. Were this requirement applied to non-profit hospital bonds, such bonds would not be available. The Constitution in most states would prohibit such a contribution and in other states facing mamouth Federal aid cutbacks, no funds would be available to make such a contribution.

The Administration proposal does state that "general tax exemptions provided for exempt organizations under State law could be used to satisfy the contribution requirement with respect to projects for exempt organizations." Id. The meaning of this qualification is ambiguous. If it means that State and local governments would not be required to make a financial contribution specifically earmarked to a project of a non-profit hospital, it would mitigate the impact of the financial contribution requirement. Adoption of such a qualification is warranted for tax-exempt organizations because State and local governments already make an indirect financial contribution to such organizations by granting them an exemption from State and local taxes. To require that such governmental units make an additional contribution to each specific project is inequitable and unreasonable. Given the tax-exempt status of non-profit hospitals, a State or local government cannot further abate the State or local taxes of the hospital. This means that any additional financial contribution to a specific project would likely have to take the form of a direct equity contributin to the project, the form of contribution that specifically is prohibited in many State Constitutions.

The key issue facing hospitals in the 1980's is capital formation. Hospitals are consuming their own capital largely due to current Federal reimbursement policies that do not cover full costs of operation and ignore the requirement to reimburse non-profit hospitals for a return on equity. The result, over time, is that hospitals increasingly are assuming greater levels of debt to replace existing assets. As this statement demonstrates restricting the tax exemption for non-profit hospital bonds would severely exacerbate the financial strain already felt by non-profit hospitals, impair their ability to renovate and modernize existing facilities, and prevent expansion in those areas mere patient needs warrant construction of additional facilities.

On behalf of Adventist Health System-West, I appreciate your consideration of these issues.

Very cordially yours,

Frank F. Dupper

Frank F. Dupper, President
Adventist Health System-West

FFD/yms

xc: Members of Senate Finance Committee

Record Mar 16

STATEMENT OF

MICHAEL E. BARBER

on behalf of the

FAMILY SUPPORT COUNCIL

of the

CALIFORNIA DISTRICT ATTORNEY'S ASSOCIATION

before the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

concerning

Administration Budget Proposals
as they relate to
Title IV-D of the Social Security Act

March 11, 1982

Mr. Chairman and Members of the Committee:

Enclosed is a resolution of the California District Attorney's Family Support Council. This resolution is based on our understanding of Office of Management and the Budget, and Health and Human Services proposal to restructure financing for child support enforcement. The resolution says simply the H.H.S.-O.M.B. proposal now before you as we understand it will injure the taxpayers directly by depriving those taxpayers of at least $150,000,000 in revenue now received from child support enforcement. It is the request of the District Attorneys of California that you drop the O.M.B. proposal, pass H.R. 4961, and leave child support enforcement funding as is until A.F.D.C. (Title IV-A of the Social Security Act) is made a state responsibility. As Legislative Representative of the Family Support Council, I am forwarding this request to you.

I hope you will bear with me as I explain why O.M.B. should be rejected on this matter, as briefly as I can. First, what we understand the O.M.B. proposal to be and why it won't work.

Title IV-D of the Social Security Act deals with proving paternity, and collecting support for all children on and off welfare. In so doing, it works both within states and across state lines. A 1973 G.A.O. study found that states and localities were doing very little in this area, primarily because of lack of real fiscal incentives and as a result A.F.D.C. costs were high and going higher. Title IV-D was then passed with 75 percent federal financial participation (f.f.p.) and 15 percent of the support collections that repaid welfare grants being rebated by the federal government to local government. From a money-losing proposition the program has gone to a dividend payer to the taxpayer. It cost $450,000,000 in 1980 to do this work, but the program took in $603,000,000 in A.F.D.C.-related child support alone. An additional $900,000,000 was collected to keep families off welfare. Viewed just from the perspective of welfare collections, the taxpayers got the dividend of $150,000,000.

H.H.S., I might add, does not appear to have told O.M.B. about this dividend to the taxpayer since this is not in the budget message before you.

The non-welfare area seems to be one of the targets of the H.H.S.-O.M.B. proposal. The following background on funding support enforcement on behalf of non-welfare, single-parent families should be helpful. The original IV-D program carried a 25 percent incentive on welfare collections, but for non-welfare work federal financial participation only and only for a limited period. Later the incentive was reduced to 15 percent and federal financial participation extended indefinitely to non-welfare enforcement efforts. Fees for this service were made optional and a pattern developed where the rural states instituted a fee but the urban states did not. Illinois was a singular exception to this pattern but has since rescinded its fee.

The reason for this split on fees is obvious. The rural states and rural areas of urban states have a strong work ethic and a social pressure against welfare dependence. Urban areas lack this restraint. Thus the fee became a barrier against perceived abuse of IV-D in rural areas. In urban areas, however, it inhibited cooperation in the IV-D program for the low-income single parent and simply proved more costly to collect than it was worth. Urban areas found that the clinic-like atmosphere of IV-D offices automatically screened out middle income cases and that the offer of this service avoided welfare dependence.

Shelby County, Tennessee (Memphis) saw the welfare caseload drop 30 percent in the first year of IV-D. Nevada saw its A.F.D.C. caseload drop from 3200 to 2300 between 1975 and 1978 instead of climbing to a projected 6000. The Ford Administration was able to state that as a result of IV-D, A.F.D.C. dropped for the first time in over thirty years.

The reason this has become important is that, unfortunately, the management of H.H.S., with its leadership drawn from welfare administration, was unable to comprehend the relationship of non-welfare support enforcement and a drop in A.F.D.C. caseloads. So in 1980 they proposed a nation-wide fee from the independent single-parent of such a magnitude that it would have discouraged drastically their participation in IV-D until the viscissitudes of life put them back on A.F.D.C.

Your Committee substituted a fee chargeable to the non-custodial parent, but that fee would have penalized the responsible parent and appears unconstitutionally discriminatory in its application. H.R. 4961 is now before you. It will repeal the whole mess putting the state option back in as it existed in

September 1981.

The matter of non-welfare service is even more important with the new limitation on welfare benefits for the working poor. To cut this group off of their limited A.F.D.C. benefits, as has occurred, and then start charging them for enforcing criminal and quasi-criminal support statutes (as H.H.S.-O.M.B. proposes) will materially add to their financial problems and lessen the inducement to work. Yet instead of accepting H.R. 4961, this is what the O.M.B. document before you appears to call for.

However, this is not all. The main part of H.H.S's proposal is to make collections which off set A.F.D.C. expenditures, pay for the whole IV-D program, withdrawing both the 15 percent incentive and the 75 percent federal financial participation. The end result will be to kill the support program and the taxpayer dividend referred to above. Because the subsidies to the states and counties have given them the bulk of this dividend, while the federal government has heretofore operated at a loss ($100,000,000), H.H.S. has attempted to reduce federal involvement, unfortunately without regard for the taxpayers for whom we all work.

The savings to the taxpayers in the program reduce local tax bills for goods and services. What is not understood at O.M.B. or H.H.S. is that prior to IV-D there was no savings to anyone and A.F.D.C. continued to grow largely at federal expense. Unless and until the federal courts are prepared to take over child support and the Justice Department to prosecute these cases, it is in the public interest to let the local government get the tax cuts involved in having an efficient program. Unfortunately, the H.H.S. staff that came up with this proposal failed to perceive this.

Because of this the following negative results will occur unless the H.H.S. proposal is dropped and present funding left in place. First, in jurisdictions that do not collect enough on A.F.D.C. to cover their costs, the program would be cut back to reach that level. While this group of states includes New York, at least some of the states in question are smaller and poorer. Arkansas, West Virginia, Louisiana, Kentucky, District of Columbia, Puerto Rico, Tennesssee, all fall within this group. These states also produce poor emigrants to the more populous states.

The first item to go in such a cutback is paternity work. If this effort is reduced, then the future support rights of a whole generation will be lost. Timeliness is esential in paternity work and the delay resulting from giving such cases low priority makes ultimate adjudication infinitely more difficult. Outward migration from such jurisdictions will create future welfare burdens without a right of reimbursement being established.

Interstate cases will get much the same treatment since the enforcement agency's job will depend solely on skimming the cream off local A.F.D.C. collections. Non-welfare cases will either have to pay a substantial fee, thus inviting welfare dependence, or expect to be placed on the back burner.

In a state like Nevada, which has effectively cut its A.F.D.C. caseload by 40 percent and therefore does not collect enough on A.F.D.C. to cover its costs but keeps many off A.F.D.C, this is a certainty.

Second, in those states where the collections on A.F.D.C. cases exceed total cost, the potential for the same prioritization that exists in the states that lose money will also exist. But the dollar saved by this even in the short run will quite probably never find its way out of the state. Thus the revenue O.M.B. projects is a chimera. This will occur because the H.H.S. proposal will in fact encourage it to happen.

It is axiomatic that in government expenditures rise to equal any fixed pool of cash available. Thus family, and sex education classes in the schools could be recast as education classes to prevent out-of-wedlock parentage and so funded by IV-D. Marriage counseling on visitation and custody could be augmented to include a financial review and thus given access to the funds left over from actual child support enforcement. Defense counsel in paternity suits could justify some claim to these funds. Given the emotional strain this job places on public staff, early retirement and increased salaries could also be justified as opposed to turning between 50 percent and 80 percent of this money back to the federal government. The incentive to spend it on non-productive efforts at the local level will be considerable.

The present federal financial participation system carries with it no such threat. Each budgetary increment in the child support program requires a new and separate appropriation of local or state funds equal to 25 percent of the item. As a consequence, each item must stand on its own merits. Also, under the present system, the program manager takes a certain level of pride in holding costs down to maximize return to his jurisdiction. But under H.H.S.-O.M.B.'s proposal, if the manager does not spend the pool of cash made available by the A.F.D.C. collection, then the local jurisdiction will in fact be injured.

Some of this undoubtedly will constitute the same kind of expenditure relief now in effect in local jurisdictions under the present system. But now the local programs must stand on their own merits to justify these funds.

However, it is likely in the future that with the lack of fiscal incentive to make such tangentially related local programs accountable on their own that new and less than worthwhile programs will be created to fill the gap. In financially strapped Michigan, this taxpayer saving as of 1980 was $50,000,000; in California, $10,000,000; in Wisconsin, $17,000,000; in Massachusetts, $22,000,000. Pennsylvania, New Jersey and Washington also produce significant taxpayer savings. Watch them disappear if the O.M.B.-H.H.S. proposal is adopted.

Fourth, federal costs will increase. It could be argued that even if the above two scenarios were adopted, in total the federal government would still be in better shape in terms of revenue than it now is. The taxpayers would have lost directly $150,000,000 in tax savings and indirectly much more in A.F.D.C.

funds because of welfare dependence, even though O.M.B. would appear whole, but the drain does not end there.

To try to prevent the expenditure of the taxpayers' $150,000,000 on irrelevant items, the federal government will have to put in the field an army of inspectors general. The inevitable lawsuits would follow with government lawyers on both sides arguing whether sex education classes could be reasonably related to paternity prevention, or arguing some other tenuous relationship of some other program. The alternative would be to spend a couple hundred million setting up a budget approval system to review all state and county child support budgets before claims could be filed thereon. This might cut down the inspectors general and lawsuits, but the cost and time involved would be enormous. Local initiative would most likely be killed and so would the only form of welfare reform to succeed in the last forty years.

Fifth, with the tangle of red tape outlined above and the priority shift and cutback in the program also referred to above, A.F.D.C. rolls would again begin to grow. By way of example as to how this would work, please note the following: Recently a cap was put on the amount that could be earned and welfare benefits still be received. The change in the law is to be applauded. I am aware of a case where the earned income exceeds $30,000 for a family of four and A.F.D.C was still being paid out because of manipulation of work-related allowances, and I have been advised that personnel in other counties have seen similar cases.

But the bulk of these cases need child support to pick up the difference lost in the welfare cutoff. These families perceive of themselves as poor and many are. They are familiar with the welfare system and know how to obtain benefits thereunder. While I doubt that many people will quit work to obtain welfare (A.F.D.C.), the slightest change in their economic circumstances will put this group back at the A.F.D.C. application window unless the child support picks up the slack.

H.H.S.-O.M.B.'s scheme for funding activity discourages enforcement of support in such non-welfare cases and will promote dismantling of existing efforts in the non-welfare area. A survey of Sacramento County's non-welfare cases even before this cutoff indicates 75 percent of them would be on A.F.D.C. but for this office's efforts. A very quick review of California counties at random shows that 60 percent to 65 percent of their non-welfare caseloads are former welfare cases. It is obvious that such families are on the knife's edge of A.F.D.C. dependence.

The cost of administering a non-welfare child support case under Title IV-D is infinitely cheaper than a Title IV-A (A.F.D.C./welfare) case. In 1980 in California a non-welfare IV-D case cost $115.15 per year to administer based on H.H.S. statistics.

Without considering the A.F.D.C. grant the average A.F.D.C. (IV-A) case in California costs $480 per year just to administer. In terms of administrative costs it is much cheaper to keep a family off A.F.D.C. Add in one or two months welfare grants to this and the cost of now setting up a welfare-related child support case, and the difference is even greater. Yet if the child support program is weakened, this is exactly what will happen and so long as Title IV-A (A.F.D.C.) is paid for out of federal funds, the extra cost will come out of the federal budget. If O.M.B. and H.H.S. are trying to increase the deficit, they could not have picked a better way to do it.

Other consequences more remote, but no less predictable, flow from this proposal. Child support enforcement as part of the divorce procedure places more people in contact with the court than any other phase of the judicial system except traffic court. Weakening the firm stand that has been taken for enforcement of support obligations weakens generally respect for law. Failure to enforce support while taxing people to pay welfare to the unsupported family encourages family formation (or simply procreating without regard to having a family) by those who are unable or unwilling to support an existing household while it discourages family formation and expansion by responsible parents. To anyone who cares about family stability, the consequences of this ought to be obvious.

When IV-D first came into effect, suspicious county administrators and prosecutors cautioned their peers against participating. These "nay sayers'" position was don't trust the federal government. That their peers did not take their advice is demonstrated by the success of the program. To adopt H.H.S.-O.M.B.'s proposal is to give credibility to the prophets of doom and discourage the local government officials who have committed themselves to support enforcement. The practical result, in addition to growing costs of A.F.D.C., will be to doom to failure the transfer of A.F.D.C. to the states under the new federalism. Without this important check rein, state costs would spiral.

To take the time to rebuild what O.M.B.-H.H.S. will wreck would take too long. The competence built up at the local level over the last six years may never be fully restored, at least not until after countless taxpayer dollars have been lost needlessly. In fact, if action is deferred and funding left in place until IV-D is transferred back to the states, this program (IV-D) as a functioning part of the transferred system would be well received. No state wants a morale shattered wreck, but a good system will be a major barrier to heavy state A.F.D.C. costs.

Further, this proposal is unnecessary. There are areas where better federal administration would produce sufficient funds to meet the federal shortfall without cutting off the taxpayers' dividend, and H.H.S. (if not O.M.B.) ought to know it.

The first is to reevaluate and reinforce the tax intercept program. This is the system whereby a tax refund is set off against past-due child support owed on a welfare case. Records held by H.H.S. secured from the states for this program show $2,000,000,000 is owed the public. Yet, unaccountably H.H.S. has estimated only $25,000,000 will be recovered this year under this program. A more realistic assessment would be $250,000,000, eighty-eight million of which would end up in the federal treasury. Thus all but twelve million of the federal shortfall will be made up by a system already in place.

Nor is this a one-year aberration. Two states, Michigan and California, have submitted tapes totaling $900,000,000 of that two billion. If the present IV-D funding system stays in place, it can be expected the increasingly straightened state governments will bring their records up to the level of California and Michigan. Also, it has been our experience in California that once a set-off procedure is established, the money continues to roll in in succeeding years. Therefore for the next several years at least this collection tool should make up the difference between federal expenditures and costs.

If the funding system is changed, however, then the loss of local support for the program will eliminate the capacity to create at the local level the necessary record to permit a setoff. To show what is not now being done, but what can be realized, the whole State of Massachusetts submitted only 6500 cases. Sacramento County, California, alone submitted 5500 cases.

Had Congress enacted legislation enabling this setoff in 1973 when it was first proposed by the undersigned, there might not be a shortfall in federal IV-D revenues now. Be that as it may, the program is on its way and so long as the present funding remains in place it can grow. Cut funding and cut off the incentive to develop this program and funds will flow into the pocket of the non-supporting parent rather than the taxpayer to whom it is owed.

The remainder of the shortfall could be made up if the federal government would, instead of trying to abort a program that pays its way and gives the taxpayers $150,000,000 over the cost, become more positive and just bring its own jurisdiction up to the level of, say, Detroit. In Detroit, total child support enforcement expenditures are approximately $6,500,000. Collections on just A.F.D.C. cases are about $24,000,000. In the District of Columbia, total program costs are $2,649,798, but A.F.D.C. collections are only $1,286,019 according to H.H.S.'s "The Annual Report to Congress for the Period Ending September 30, 1980." In Guam the same report says $142,929 was expended but only $102,826 collected on A.F.D.C. cases. For Puerto Rico the figures are $921,897 expended, $626,322 collected; and for the Virgin Islands the figures are $444,953 expended, $131,051 collected.

If H.H.S. and O.M.B. could just bring these areas up to the level of Detroit, collections would be just short of $15,000,000 and net revenue to the federal government of $11,000,000 instead of the present $2,000,000,000 loss. However, instead of putting their own houses in order, O.M.B. and H.H.S. have elected to reduce funding and therefore effectiveness of a state and local effort that yielded to the taxpayers according to the same report $152,000,000 and saved untold millions more by keeping thousands off welfare.

Governor Reagan in March 1971 stated to the California

Legislature:

> "Too many families are on welfare because of the failure of parents, usually the absent father, to contribute to the support of their children. Where a parent is capable of supporting his children, but refuses to do so, the fairest solution is to legally enforce his obligation rather than force the taxpayer to make up for the parent's unwillingness to provide adequately for his own offspring."

The vast majority of states and counties have responded to this call to action. The result has been the only form of welfare reform in the last forty years that has worked. To now permit O.M.B. and H.H.S. bureaucrats to undercut this effort by their ill-conceived funding scheme is to neither serve the President nor the public.

As is demonstrated above, H.H.S. on its own could have set in motion initiatives that would have met the funding targets of O.M.B., and O.M.B. could have identified these initiatives if it had just read the reports sent by H.H.S. to Congress. Their proposal now before you is unnecessary.

The IV-D program now pays a $152,000,000 dividend to the taxpayers. It is not "broke". Please ignore H.H.S.'s plea; instead pass H.R. 4961, and otherwise leave it as it is. It doesn't need fixing.

I thank the Chairman and the Committee for permitting me to present these views.

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RESOLUTION

DISTRICT ATTORNEY'S FAMILY SUPPORT COUNCIL

February 18, 1982

WHEREAS, the child support enforcement program operating under a funding system providing for 75 percent federal matching funds and a 15 percent federal incentive:

1) has provided the taxpayer with a consistent profit over the costs;

2) has automatic cost controls built in because of the 25 percent local and state contribution to funding and the incentive;

3) provides a sound basis for long-term cost avoidance in the determination of paternity and the enforcement of non-welfare cases; and

4) creates the basis for an effective federal tax intercept program which shows promise of profiting not only the taxpayer in general but the federal government; and

WHEREAS, the proposed federal restructuring of the funding system by basing funding entirely on collections that offset Aid to Families With Dependent Children (A.F.D.C.) grants would:

1) encourage a rise in costs to equal collections;

2) reduce the overall benefit to the taxpayer without meaningfully increasing the profit to the federal government;

3) destroy the paternity determination and non-welfare enforcement programs; and

4) eliminate interstate cooperation; and

WHEREAS, the recently enacted legislation imposes mandatory 10 percent fee on obligors in non-welfare cases, replacing the former system of eptimal fees:

1) is confusing and ambiguous;

2) discriminatory in its application;

3) administratively unfeasible; and

4) deleterious to cost-effective collection systems; and

WHEREAS, any mandatory fee system in non-welfare cases:

1) interferes with the concept of federalism because the states should be fair to carry out their own public policies;

2) has been rejected or tried and found counterproductive by the majority or urban states and high volume states; and

3) will have the tendency to encourage welfare dependency, particularly in view of new welfare eligibility standards; and

WHEREAS, the federal government has not given adequate attention to more effective means of increasing effectiveness such as:

1) evaluation of cost avoidance in the welfare system;

2) encouraging the collection of interest and the assessment of attorneys fees and costs in both welfare and non-welfare cases;

3) simplified wage assignments; and

4) increased evaluation, training and assistance to individual states and localities in improving their programs; and

WHEREAS, stability in funding systems and expressed commitment to the program by the federal government is essential to program planning and budgeting by the individual states and localities;

NOW THEREFORE BE IT RESOLVED, that the California District Attorney's Family Support Council urges:

1) The current funding system should be retained;

2) The mandatory fee provision be replaced and the question of fees be left to the option of the states; and

3) Health and Human Services and Congress review the traditional methods of recovering costs in the enforcement of family law cases.

BE IT FURTHER RESOLVED, that copies of this Resolution be sent to appropriate federal agencies and congressional committees.

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DISTRICT ATTORNEY'S FAMILY SUPPORT COUNCIL

February 18, 1982

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STATEMENT OF THE
NATIONAL ASSOCIATION OF PRIVATE PSYCHIATRIC HOSPITALS
TO THE
SENATE FINANCE COMMITTEE
ON
FISCAL YEAR 1983 BUDGET
PROPOSED MEDICARE BUDGET REDUCTIONS
MARCH 1982

Mr. Chairman:

The National Association of Private Psychiatric Hospitals appreciates the opportunity to react to the fiscal 1983 Medicare budget cuts proposed by the Administration. We have serious reservations about unilateral actions taken without the benefit of a long term approach to restructuring a total system. We feel many of the proposed reductions are short term in nature and will do nothing to control costs over the long haul.

At the outset we must state that we are unalterably opposed to the 2% reduction in Medicare hospital reimbursement. It would cut payments to hospitals across the board, disregarding their efficiency, costs, case mix, intensity, or occupancy. We oppose cuts which are arbitrary, inequitable, and do nothing to resolve the real problems facing the Medicare program. Furthermore, such a cut would penalize those hospitals serving a higher proportion of Medicare beneficiaries. This seems totally punitive towards those hospitals committed to serving the Medicare population.

The National Association of Private Psychiatric Hospitals represents the nation's 203 freestanding (nongovernmental) psychiatric hospitals and related hospital-based psychiatric services. The hospitals, with over 24,000 beds, represent a variety of types of ownership and provide for the medical care and treatment of persons suffering from psychiatric disorders and impairments. The membership offers the wide and varied range of competitive hospital-based programs critical to addressing the needs of children, adolescents, adults, the elderly, the alcoholic, and the substance abuser. All of our member hospitals are accredited by the Joint Commission on Accreditation of Hospitals, the national agency for voluntary accreditation of hospitals.

We would like to take this opportunity to comment on some of the proposals mentioned in the administration's budget recommendations, as well as comment on some proposals not yet introduced but under active consideration by the administration.

Specific Proposals:

Repeal Waiver of Provider Liability

This provision would repeal a prior amendment passed by Congress to protect both institutions and beneficiaries from a retrospective denial of reimbursement for services. We believe this provision would unjustifiably penalize institutional providers which have delivered care deemed medically necessary and appropriate on the orders of physicians and other health professionals. Since physicians, not hospitals, order such services, such a repeal under Part A would be unfair.

Elimination of Utilization Review Requirement/HCFA/Private Sector Utilization Review Initiative

While agreeing in concept to the elimination of burdensome regulatory activities for hospitals, we are concerned that this proposal, established to save in excess of $300 million, has not yet been fully developed or articulated. We would and do strongly object to returning to a system which would vest the intermediary and third party payor with the responsibilities of reviewing care or determining the criteria under which care is deemed medically necessary or appropriate. Such a system would revive the arbitrary and capricious retrospective denials of care, which the psychiatric hospital is all too familiar with.

This association has endorsed the elimination of the PSRO program and is committed to developing a system which will remain institution specific in allowing the individual hospital utilization review committees to develop norms for admissions, lengths of stay, discharge criteria, et. al. Such a system would allow each institution to develop norms applicable to its setting, treatment goals, treatment objectives, and unique capabilities. Any system developed only with the payor's interest in mind would be unfair and in the long run more costly to a system, only encouraging inappropriate utilization or under utilization.

Medicare Contractor Initiative

This proposal would eliminate the providers' ability to nominate their own intermediary. Presently, the Secretary is required to assign intermediaries based on published standards and criteria for efficient administration. The proposed amendment would remove such a requirement. We feel such a proposal would be a detriment to the system.

Other Proposals:

Expanding Section 223 Limitations

While this proposal has not been formally introduced as part of the FY 83 budget, the Department continues to give active consideration to lowering Section 223 limits and expanding them to ancillary services. The specialty psychiatric hospital has long had difficulty in being reimbursed for what has been considered routine for their programs. The true cost of providing medically neccessary psychiatric care must include therapeutic services, i.e. education, social services, and therapeutic modalities. Such services are required of specialty hospitals under the Conditions of Participation for the Medicare program. However, they are rarely reimbursed. A further tampering with the 223 limitations would seriously limit the specialty hospital's ability to be adequately reimbursed and most likely would result in the hospital's inability to continue to adequately treat the Medicare population.

Propsective Reimbursement System

This Association stands ready to assist the committee and other interested parties as they explore alternatives to the present cost based, retrospective reimbursement system.

Such a system, however, must not penalize hospitals and must allow for such factors as intensity, case mix, efficiency, labor costs, debt financing, inflation, and demand.

The Association believes that the health care system has moved in the direction of greater competition and encourages this movement. While increased competition in the health care system may slow down escalating costs, any "pro-competitive" approach should be implemented with thoughtful regulation in order to assure that consumers have adequate information about competing health plans and to protect unsuspecting consumers from plans which exclude necessary services.

Competition among health plans must be based on differences in deductibles, co-payments, catastrophic stop-loss contributions, and supplemental services. In addition, a basic package of minimum benefits must be maintained for all qualified competition health plans. Such a package should include all medically necessary physician and hospital services with no distinctions made between any medical specialties.

In conclusion, we believe a framework is crucial to assure adequate and continued reimbursement for all appropriate costs attributable to the Medicare program designed with incentives for the long term solvency of the program, minimizing cost shifting, assuring a catastrophic element not now found within the program, beneficiary cost sharing, and allowing for adequate planning to meet increasing demands.

Mr. Chairman, we thank you and the committee for giving us the opportunity to comment and we look forward to working with you as you consider the above proposals.

STATEMENT OF
MICHAEL D. BROMBERG
EXECUTIVE DIRECTOR
FEDERATION OF AMERICAN HOSPITALS
COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE
ON
PROPOSED MEDICARE BUDGET CUTS
MARCH 1982

Summary of Testimony

We urge you to reject arbitrary cuts in the Medicare budget which do not reform the current system. Instead we urge you to accelerate efforts to bring marketplace competition and restraints on utilization to the system by enacting the following legislative proposals:

(1) A ceiling on tax-free employer purchased health benefits designed to encourage the offering of multiple insurance plans;

(2) Benefit redesign to require reasonable cost sharing by Medicare beneficiaries during the first 30 or 60 days of a hospital stay up to a catastrophic level in order to encourage restraint in utilization;

(3) A voluntary Medicare private insurance option as proposed in H.R. 4666 sponsored by Representatives Gephardt and Gradison; and

(4) Development of a Medicare prospective payment schedule for hospital services and the elimination of cost reimbursement.

These four changes would address the underlying problems in the current system and would alleviate the need for arbitrary cuts in the Medicare program. Enactment of a ceiling on tax-free health benefits and passage of Medicare benefit redesign with restructuring of cost sharing would produce immediate budget savings and increased revenues substantially in excess of those cost reimbursement cuts which we oppose. These two proposals could reduce the budget deficit by more than $3 billion compared to the $1.1 billion in hospital cuts contained in the proposed fiscal 1983 budget. Enactment of a Medicare voucher option and a prospective rate system might not produce immediate first year savings but would produce substantial dollar savings in the second and future years.

We strongly oppose the proposed two percent cut in cost reimbursement to hospitals. It is an arbitrary proposal which calls for an across the board cut to all hospitals, disregarding their relative efficiency, costs or caseload.

Mr. Chairman and Members of the Subcommittee, my name is Michael D. Bromberg, Executive Director of the Federation of American Hospitals.

The Federation of American Hospitals is the national association of investor-owned hospitals and hospital management companies, representing over 1,000 hospitals with over 115,000 beds. Our member hospital management companies also manage under contract more than 300 hospitals owned by others. Investor-owned hospitals in the United States represent approximately 25 percent of all non-governmental hospitals. In many communities investor-owned facilities represent the only hospitals serving the population.

We appreciate this opportunity to react to the fiscal 1983 Medicare budget cuts proposed by the Administration. In general we have serious reservations about the short term reductions in hospital reimbursement contained in a list of proposed regulations and proposed legislation. These short term savings total more than $1.1 billion in hospital reimbursement arbitrarily reduced by strained attempts to justify new definitions of allowable cost reimbursement.

This annual charade has been going on since 1966; however, the scope of the reductions in cost reimbursement has reached an all time high this year. Proposed cuts in hospital reimbursement are two and three times higher than proposed cuts affecting other providers and beneficiaries. As we address these individual cuts and express our opposition to them, it is important to keep in mind that all of the short term proposals are directly related to definitions of retrospective cost reimbursement, a system which pays too little and contains perverse incentives.

This Administration, like others before it, recognizes that cost reimbursement has fueled health expenditure increases and needs to be replaced by a system which turns around the incentives in order to reward management efficiency and restrain utilization. We are very supportive of the system reform proposals being developed by the Administration and by Members of this Committee. Specifically we urge you to reject arbitrary cuts in the Medicare budget which do not reform the current system. Instead we urge you to accelerate efforts to bring marketplace competition and restraints on utilization to the system by enacting the following legislative proposals:

(1) A ceiling on tax-free employer purchased health benefits, designed to encourage the offering of multiple insurance plans;

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COMMENTS ON SPECIFIC ADMINISTRATION PROPOSALS

Two Percent Reduction in Medicare Hospital Reimbursement

This proposed amendment would reduce Medicare hospital reimbursement from 100 percent allowable cost reimbursement to 98 percent of allowable costs. It would cut payments to hospitals by $653 million even though these dollars represent actual hospital expenses. Medicare reimbursement is already far below what can be considered fair payment for services rendered to program beneficiaries. This arbitrary proposal calls for an across the board cut to all hospitals, disregarding their relative efficiency, costs or caseload. We strongly oppose this inequitable cut. We cannot find any merit to the proposed two percent cut which does nothing to resolve the real causes of increasing costs in the Medicare program.

Repeal Waiver of Provider Liability

This provision would repeal a prior amendment passed by Congress to protect both hospitals and patients from retroactive denials of reimbursement for services reasonably believed to be necessary at the time rendered but subsequently found to be unnecessary.

We believe Congress was correct in its prior decision to enact this change, particularly since physicians rather than hospitals order these services. By imposing penalties on the hospital under Part A reimbursement, the proposed repeal would be most inequitable.

Medicare Contractor Initiative

This legislative proposal would eliminate provider nomination of intermediaries and we believe such a change is unnecessary. Under present law the Secretary may reject an intermediary nomination where he finds it is not in the best interest of efficient and effective administration. The proposed amendment would take away the due process right of providers or intermediaries which requires the Secretary to make that decision based on published standards and criteria for efficient and effective administration.

We believe that experimentation with negotiated fees between the Secretary and intermediaries can be conducted without sacrificing competition by simply allowing all intermediaries to contract at the fixed fee rate and retaining a pluralistic intermediary system.

Length of Stay-Utilization Reduction Program

This regulatory proposal is estimated to save $330 million. While details have not been released, we believe the program will include instructions to Medicare intermediaries in areas of high average length of stay or high utilization to reduce hospital utilization by various means. We believe this approach has some merit provided it does not lead to arbitrary actions and a return to problems encountered in early years of the program when retroactive denials were more common than today.

Since physicians, not hospitals, are legally and medically responsible for determining length of stay and utilization of services, it would be unfair to penalize hospitals retroactively for orders issued by physicians. Where utilization decisions are properly reviewed by hospital review committees, no penalty should be imposed in the absence of prospective guidelines. We will want to carefully study the details of this program when they are published.

Elimination of PSRO Program

We support the proposal to repeal the PSRO program. We believe the private sector can do a better job in evaluating utilization decisions than a regulatory program. We will study forthcoming proposals to establish a program for contracting out this function on a limited basis. This is an area where local coalitions can play a meaningful role.

Eliminate Private Room Subsidy

This regulatory proposal would reduce cost reimbursement by offsetting private room revenues from certain Medicare patients who voluntarily elect such accomodations. The Administration argues that private room costs should be excluded from routine cost finding under Medicare; however, Medicare regulations do not allow hospitals to separately identify Medicare private room or sub-intensive care unit costs. We oppose the regulatory proposal as presented by the Administration and instead urge you to specify that additional cost centers be allowed in the cost finding process for these types of services.

Cost Sharing

The Administration budget documents discuss cost sharing in connection with the health care competition proposal to be submitted to Congress in the near future. Part of that plan will call for a modest coinsurance rate on all hospital days following the first day and will provide catastrophic coverage, including unlimited hospital days, limiting total cost sharing under Parts A and B to $2500 per year. No budget savings are projected since the details of the plan have not been finalized. The Congressional Budget Office has estimated that 10 percent of the deductible cost sharing from the second day through the 30th day would save over $1 billion in the first year.

More important than sharing costs is the impact that consumer participation would have on utilization.

A large body of economic analysis strongly supports the conclusion that financial incentives have a significant impact on utilization. Utilization goes down as cost sharing goes up. Here are some typical findings:

> A ten percent increase in the price of inpatient services reduces demand between five and seven percent. (Feldstein, Martin, "The Welfare Loss of Excess Health Insurance," Journal of Political Economy, 1974.)
>
> A 100 percent decrease in the price of ambulatory services would raise demand by 120 percent. (Newhouse, Joseph, Charles Phelps, and William Schwartz, "Policy Options and the Impact of National Health Insurance," New England Journal of Medicine, 290 (1974) pp. 1345-1359.)

Increasing Demand

Because the proportion of the population over 65 will increase markedly over the next decade, the utilization of health care services per capita is expected to increase dramatically under the status quo. Medicare expenditures, even after being adjusted for inflation, are expected to increase by 60 percent from 1980 through 1985.

Among the major contributing factors to hospital cost increases are admissions and intensity. The percentage increase in total hospital admissions has been stable at between 2.5 and 2.9 percent annually since 1977 except for a relatively low 0.4 percent increase in 1978. The intensity increase has been caused primarily by increased admissions of patients over age 65.

The cost of treating over age 65 patients generally is more than two times the cost of treating patients under age 65 in hospitals. The following chart illustrates the admission intensity trend:

Percentage Increase in Admissions	1978	1979	1980	1981 (6/80 to 6/81)
Under age 65	1.0	1.7	1.5	0.4
Age 65 and older	4.9	5.3	6.7	5.3

The intensity area also includes technological advances which save and prolong lives and are costly. There are many social, ethical and economic questions which can be raised in this area, but an aging society demands more intensive health care.

During the past twelve months admissions of over age 65 patients rose about five times the rate of under age 65 admissions. Demand is the single most serious aspect of hospital cost increases and until demand is addressed, there will be no solution to health care inflation.

A Market Strategy

The large body of studies examining the causes of health care expenditure growth all point to the same conclusion: The problem is not inefficiency but utilization -- patients, freed from the burden of payment, demand more; and physicians, unrestrained by cost-based reimbursement, provide more.

Our present system of health care financing has desensitized providers and consumers to the true costs of health care through the extensive use of first dollar coverage and low copayment rates. The situation has been aggravated by cost reimbursement which encourages excessive spending. The result is intense quality competition but little price competition.

Restoring cost consciousness to providers and consumers is intrinsic to any solution to rising health costs. Without price awareness, demand for health services is infinite. That is why we urge you to substitute proposals for a ceiling on tax free health insurance premiums, cost sharing, a voucher option, and a Medicare prospective payment system for the cuts proposed by the Administration in Medicare reimbursement.

Other Regulatory Options

Three regulatory cost control options which have not been recommended by the Administration in its budget proposals are expansion of section 223 limits to all Medicare hospital costs per admission, reliance on state rate controls and reduction in the rate of return on equity capital for proprietary providers. We strongly oppose these measures.

Section 223 limits on per admission costs would require use of a complex methodology for grouping hospitals and case mix. A large number of exception requests would be filed as every hospital argues that it differs from others due to the mix of patients and diagnoses. Physicians would be tempted to upgrade diagnoses and admit marginal cases to maximize reimbursement. A larger bureaucracy would be needed to administer this kind of program. There would be no incentives for efficiency since the system would still be cost based.

A review of state rate controls indicates little difference in expenditure growth on a per capita basis between the seven states with controls and all other states. 1980 per capita hospital costs rose 13.6 percent in rate control states compared to 13.7 percent in all other states -- an insignificant difference. When New York is excluded, the per capita increase was 1.2 percentage points greater in the rate control states -- 14.9 percent compared to 13.7 percent for non-control states. Maryland also incurred per capita increases of 13.9 percent -- also above the increase for other states.

Hospital care is more expensive in states with mandatory rate setting programs. In 1979, per capita hospital expenditures for the seven states with mandatory programs were $305 versus $272 for non-mandatory states.

New York, which has the oldest and most advanced rate setting program, also has a hospital system which is in very poor financial health. Between 1974 and 1978, New York voluntary hospitals had to use almost $500 million in hospital reserves to finance current operating losses. At that rate it will only take 15 years before the total equity of all the 222 voluntary hospitals in New York is consumed. Although demand for services and patients served increased during the 1974 to 1978 period, the number of voluntary and public hospitals declined 5.4 percent.

Although New York has reduced its hospital expenditure growth rate more than any other mandatory rate setting state, the penalty probably is more than other states would be willing to bear. Liquidating a hospital system to save money is like demolishing the rooms of a house to cut energy costs.

An adequate rate of return on equity capital is necessary to protect the hospital's financial integrity and maintain its credit and to reward investors at a level commensurate with the risk assumed in making their investment.

Investor-owned hospitals pay taxes -- federal, state, city, property. In no other industry are income taxes not recognized as an operating expense for purposes of cost based reimbursement or rate of return. Eliminating income taxes as a reimbursable cost has effectively reduced the return on equity for investor-owned hospitals. Even though the Medicare return on equity payment rate is near its historic high, it still is substantially below the rate of return on equity earned by American industry as a whole. For example, the pre-tax return on equity for the Standard and Poor 400 industrials was 30.8 percent in 1979 and 27.5 percent in 1980.

By contrast, the Medicare return on equity allowance was 13.7 percent in 1979 and 16.5 percent in 1980.

On an after-tax basis, the Medicare allowed rate of return on equity capital is also substantially lower than the after-tax return on equity for the Standard and Poor 400. In 1980 the after-tax Medicare turn on equity allowance was 9.5 percent as compared to a 14.9 percent after-tax return on equity for the Standard and Poor 400. Investor-owned hospitals must be allowed a fair return on investment in order to remain viable.

These regulatory strategies cannot be effective without sacrificing quality and we urge you to reject them.

Medicare Prospective Rates

After fifteen years of rhetoric on the perverse incentives of cost reimbursement, we believe it is time to develop a Medicare prospective payment system.

A new system acceptable to the government should certainly include budget savings and predictability, administrative simplicity, incentives for efficient delivery of services, the ability to install the new method quickly, and consistency with the competition strategy.

The hospital industry will certainly want assurances that the new system will be equitable, will enable hospitals to recover their full financial requirements and involve less regulation.

Other third-party payors will look at the system to see whether it minimizes cost shifting.

Beneficiaries will certainly be concerned about the scope and equity of any cost sharing elements as well as freedom of choice of providers.

The concerns of the various parties involved can all be satisfied by following these guidelines:

(1) Establish a prospectively determined Medicare payment schedule;

(2) Permit hospitals to charge beneficiaries the difference between the Medicare rate and hospital charges up to some catastrophic level;

(3) Recalculate the Medicare rate annually based on average charges or based on an index which reflects hospital input price and wage increases and capital costs in a geographic area; and

(4) Avoid complex formulae which rely on diagnostic related groupings and which result in a large number of exception requests.

These principles would assure hospitals of the opportunity to recover their financial needs (although it would not guarantee recovery if their prices are too high). They would assure beneficiaries of catastrophic protection which they do not have under current Medicare law. They would minimize cost shifting by redesigning the time of copayment. They would save dollars and provide budget predictability to government. Finally, they are consistent with the competition strategy of the Administration stressing consumer choice and incentives for restraint in utilization.

This is truly an historic proposal whose details as of now are unknown but whose objectives are timely and virtually uncontested. The hospital industry owes it to the public, government, and itself to carefully and constructively review the Administration's plan when it is unveiled in the near future. It may well turn out to be revolutionary enough to free hospitals from arbitrary Medicare regulations and from the future threat of even more arbitrary cutbacks in payment for quality care.

We are anxious to work with the Committee Members and staff to explore the idea of developing a Medicare prospective payment schedule as soon as possible.

Conclusion

Last year's Reconciliation Act cut Medicare expenditures by more than $1 billion. The Administration's fiscal year 1983 budget proposes a $2.5 billion reduction in Medicare. Cuts of this magnitude without true reform are intolerable.

We urge this Committee in its recommendations to the Budget Committee on the First Budget Resolution to modify the Administration's proposed spending levels for Medicare and to immediately address the underlying problems of the current system through changing tax incentives, restructuring beneficiary cost sharing, providing a Medicare private insurance option and developing a prospective payment system for Medicare.

Passage of a tax on employer-paid health insurance in excess of $150 per month for a family of four and the restructuring of patient coinsurance could reduce the fiscal 1983 deficit by $3.7 billion and would save $10 billion in fiscal 1987 according to Congressional Budget Office estimates.

	1983	1987
Revenue Gain		
Tax Excessive Employer-Paid Health Insurance		
Income Tax	2.0 billion	6.0 billion
Payroll Tax	0.6 billion	2.1 billion
Subtotal	2.6 billion	8.1 billion
Expenditure Reductions		
Restructuring Coinsurance		
Savings	1.1 billion	1.9 billion
Total Reduction of Budget Deficit	3.7 billion	10.0 billion

Source: CBO Report, "Reducing the Federal Budget Deficit," February 1982, pp. 196, A-72, B-40.

If these two changes in the law were coupled with passage of a voluntary Medicare voucher option and a prospective Medicare hospital payment system, savings would increase substantially in fiscal 1984 and could double by fiscal 1987.

Mr. Chairman, we thank you and the Members of the Subcommittee for this opportunity to present our association's views on the proposed Medicare budget.

CENTEX CORPORATION

March 15, 1982

Senate Finance Committee
2227 Dirksen - Senate Office Building
Washington, D. C. 20510

Attention: Mr. Robert E. Lighthizer,
Chief Counsel

Dear Sirs:

We would like to submit this letter as written testimony in the Senate Finance Committee Hearings this week.

By way of background, Centex Corporation is a diversified company with annual revenues of over one billion dollars. Our largest business is as a general contractor in the construction industry, where our annual revenues are presently about $500,000,000.

We are strongly opposed to the recent proposal of the Treasury Department to eliminate Completed Contract Tax Accounting for the construction industry.

We object to the Treasury Department proposal on Percentage of Completion Tax Accounting, because a construction company can not accurately determine the amount of profit or loss on a construction contract until the project has been:

- substantially completed, and
- accepted by the owner.

Until that point, a construction company is vulnerable to the adverse impact of factors beyond its control, including:

- weather delays,
- strike delays,
- increases in costs due to inflation, and
- the failure of a subcontractor, a supplier or an owner to perform on a timely basis, due to bankruptcy or otherwise.

The risks in the construction industry are increased because of the prevalence of lump sum or guaranteed maximum prices. All the construction contracts we obtain through competitive bidding (including all of our Government

4800 REPUBLIC NATIONAL BANK TOWER, DALLAS, TEXAS 75201, TELEPHONE (214) 748-7901

contracts) have a lump sum bid price. The other contracts which we obtain on a negotiated basis almost always have a guaranteed maximum price. A construction company is 100% at risk for any cost overruns in excess of the lump sum bid price or the guaranteed maximum price.

Percentage of Completion Tax Accounting would result in a tax on an "estimate" of the eventual profit, before the profit were actually known and before it were actually earned. That would obviously be unfair.

The IRS auditors could have a field day with Percentage of Completion Tax Accounting. With the benefit of hindsight, they could propose higher taxes for any job on the basis of either the percentage of completion claimed or the amount of profit estimated by the taxpayer at the end of each year.

We also object to the Treasury proposal on Progress Payments Tax Accounting, because it would be a tax on cash flow, the first such instance we are aware of in the United States. There is no correlation between the ups and downs of the cash flow during the course of construction and the eventual profit or loss on the job.

The Progress Payments method could cause a company to pay taxes during the course of a job that could exceed the eventual profit on the job. The Progress Payments method would tax a job that had a positive cash flow, even if it were expected to be unprofitable at the time it were completed.

As you know, the Completed Contract Tax Accounting method has been used in the construction industry for over 60 years. It has stood the test of time, and there is no need to discard it.

For the above reasons, we urge the Senate Finance Committee to retain Completed Contract Tax Accounting for the construction industry.

Sincerely,

Frank M. Crossen

Frank M. Crossen
Chairman of the Board

FMC:jkr

STATEMENT
OF
AMERICAN TRUCKING ASSOCIATIONS, INC.
ON
CORPORATE MINIMUM TAX
COMMITTEE ON FINANCE
U. S. SENATE
MARCH 15, 1982

The American Trucking Associations, Inc. (ATA), appreciates this opportunity to present the trucking industry's views on the Administration's proposal to revise and expand the corporate minimum tax.

ATA is the national association of the trucking industry. It has affiliated associations in each state and thirteen national conferences. ATA represents every type and geographical scope of trucking operation in the United States. The great majority of these carriers would be impacted by these proposed changes.

Less than a year ago, we testified before this Committee and asked that you give consideration to a legislative proposal allowing motor carriers to write off as an ordinary deduction their loss in investment of an asset unique to the motor carrier industry. Many carriers had expended substantial sums in the past to purchase operating rights for use in their business, and these rights had been rendered worthless by the Motor Carrier Act of 1980. The economic loss that resulted seriously threatened the financial stability of the industry. As Congress suggested in the report accompanying the Motor Carrier Act, equity demanded legislative action.

In accordance with that suggestion, this Committee initiated the legislative action to clarify the Internal Revenue Code so as to expressly allow an ordinary deduction for operating rights over a 60-month period. The Committee on Ways and Means and the President's substitute tax bill, as adopted by the House of Representatives, contained an identical provision to that passed by this Committee. The

Senate amendment became Section 266 of the Economic Recovery Tax Act of 1981, which was enacted into law on August 13 of that year, only 7 months ago.

The deduction for operating rights in Section 266 allows the motor carrier nothing more than the loss which was sustained in 1980 when the adoption of the Motor Carrier Act stripped them of their value. Therefore, because of the non-recurring nature of this write-off, it is unique among the proposed tax preferences, in that it will not result in future action or investment by the taxpayer that might eliminate his tax liability completely unless limits are placed on its use. The events giving rise to the deduction under Section 266 are in the past. The provision allows a deduction for the future only because Congress chose to spread this loss over 60 months.

It must be emphasized that Congress already has acted to reduce the tax deduction realized by the carriers from this write-off. Instead of allowing the carriers to deduct their loss in the year the operating rights became worthless, when worthless assets ordinarily are written off, Section 266 requires that this loss be taken over a five-year period. Treating the deduction as a preference item would amount to a retroactive amendment of this provision to stretch out its benefits even further.

Such a result would come as a severe blow to the trucking industry in view of its already weakened economic condition. The changes brought about because of the passage of the Motor Carrier Act, coupled with the poor state of the economy, has had a serious adverse financial impact on the motor carriers and their employees.

Preliminary results for the third quarter of 1981 indicate that profit levels declined 12 percent from the already depressed third quarter earnings of 1980. In addition, it is estimated that 100,000 of the 400,000 Teamsters nationwide currently are on lay-off status and more than 50 carriers, many of substantial size, have closed their doors causing more than 17,000 employees to lose their jobs since the Motor Carrier Act was passed. Because of its depressed financial condition, the industry's taxable income is down substantially. Yet, the lower a carrier's earnings, the more likely it wil be subject to minimum tax, if the Section 266 deduction is treated as a preference item.

As ATA has indicated, the deduction of operating rights allowed by this provision is not a tax incentive for future investment like the other items listed as tax preferences, but a recognition for tax purposes that a loss was sustained in the past. Including this deduction as a tax preference would amount to a retroactive amendment of Section 266 which, in many instances, would spread the loss sustained by the carriers in 1980 over an even longer period than 60 months. Such treatment could further penalize motor carriers by imposing a burdensome minimum tax solely because profit levels have been severely reduced since the passage of the Motor Carrier Act. We urge the Committee not to curtail the provisions of the recently passed Section 266, but instead to eliminate the deduction for operating rights from the tax preference list.

NATIONAL TAX EQUALITY ASSOCIATION

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STONY BROOK, NEW YORK

March 16, 1982

Mr. Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lighthizer: re: FY 1983 Tax Proposals

The National Tax Equality Association (NTEA) appreciates this opportunity to comment briefly on the taxation proposals as outlined in the President's fiscal year 1983 budget.

This association was organized in 1943 by businessmen who sought an effective means of expressing their concern about the tax-favored position of cooperatives with which their own businesses were competing. Firms in the grain, lumber, coal, feed, fertilizer, cotton and seed industries were represented by NTEA in its early years. Other businesses, including commercial banks, have joined in subscribing to the association's program.

Over the years, NTEA has undertaken to persuade Congress to reduce the tax advantage enjoyed by cooperatives vis-a-vis private corporations. NTEA can therefore be considered as primarily a single-issue organization. However, one primary observation overrides our stated concern. We believe that it is imperative for the Congress to send a signal quickly to the financial markets that Congress is serious about reducing the expected FY 1983 budget deficit. We believe that this is an undertaking which transcends traditional election year politics.

Although NTEA does not pretend to advance the entire solution to the deficit-interest rate problem facing U.S. taxpayers, we do believe that a tax policy neutral in its incidence and effects is highly desirable. As one step towards achieving this tax policy, NTEA advocates the elimination of the special cooperative corporation tax privileges as outlined in IRC Section 521 and Subchapter T of the Internal Revenue Code. The Congressional Budget Office has estimated that the loss of federal revenue, the "tax expenditure," due to these provisions is $670 million in FY 1983.

This taxation proposal has not been addressed by the present administration in its budget recommendations. It has, however, been the subject of controversy, hearings, proposed legislation and Treasury rulings almost continuously since 1947.

The cooperative business in the United States is today BIG BUSINESS in every way -- except for tax status. Seven cooperative corporations now qualify among the Fortune magazine list of the 500 largest U.S. industrial corporations. Three cooperatives listed assets in 1980 of at least $1 billion. Farmer cooperative corporations had combined business volume in 1979 of $56.3 billion. Despite all of this, cooperative corporations pay virtually no federal corporate income tax.

Cooperatives pay such low taxes because, unlike their competitors, a tax is not levied on any profits which the cooperative returns or allocates to its owners. This tax treatment is essentially a deduction from corporate income tax liability for dividend allocations. Since most cooperative earnings go into refunds to owners, the income taxes paid by co-ops are very small. Generally, the co-op effective tax rate is below 10%.

Additionally, present law enables cooperatives to generate significant amounts of untaxed earnings for expansion of their business, an advantage not enjoyed by private-investor owned businesses. This occurs because present tax law requires that only 20% of the earnings allocation be in cash. The balance of the co-op profit is often returned to the patron in certificate form--bearing no interest. Allowing a deduction from corporate tax liability for dividends not paid in cash results in a substantial pool of tax-free funds for capital expansion. Although many firms would prefer this system of taxation, all object when only a limited few are so favorably treated.

Accompanying this letter is our proposed revision of the cooperative taxation scheme. We respectfully request that this proposal be made a part of the Committee record along with this letter. In general, it may be said that our proposal taxes co-op businesses on the same basis as other businesses and that it treats the dividends paid by co-ops in the same way that the dividends of ordinary businesses are treated. The right of cooperative corporations to exist in our economy and to grow unaided by federal tax subsidies is neither involved nor questioned by this legislation.

Thank you.

Sincerely,

Ray M. Stroupe

Ray M. Stroupe

97th Congress
2nd Session

H.R. ______________

To amend the Internal Revenue Code of 1954 to provide for the equal corporate income taxation of certain cooperative corporations and competing investor-owned businesses.

IN THE HOUSE OF REPRESENTATIVES

1982

Mr. __________ of ____________ introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1954 to equalize the taxation of certain cooperatives.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

That this Act may be cited as the "Tax Equalization Act of 19 ".

Sec. 2. TAXATION OF COOPERATIVE CORPORATIONS.

(a) Part IV (relating to farmers' cooperatives) of subchapter F. and subchapter T (relating to cooperatives and their patrons), of chapter 1 of the Internal Revenue Code of 1954 are repealed.

(b) Part IX (relating to items not deductible) of subchapter B of chapter 1 of such Code is amended by adding at the end thereof the following new section:

"SEC. 280. PATRONAGE DIVIDENDS PAID BY COOPERATIVE CORPORATIONS.

"(a) No deduction or any other allowance which has the effect of reducing gross income shall be permitted to cooperative corporations for amounts paid or accrued as 'patronage dividends' by such corporations.

"(b) DEFINITIONS.—

"(1) COOPERATIVE CORPORATION.—For purposes of this section, the term 'cooperative corporation' means a corporation (A) that calls itself a 'cooperative' or 'co-op', (B) that represents to any persons or classes of persons which deal with it that their patronage will or may entitle them (i) to the payment, either actually or constructively, of patronage dividends, or (ii) to an equity interest in any of the corporation's assets, or (C) that is otherwise operated for the mutual benefit of persons or classes of persons that deal with it; but such term does not include a mutual insurance company or any corporations otherwise exempt under this chapter.]

"(2) PATRONAGE DIVIDEND.—For purposes of this section, the term'patronage dividend' means an allocation or a distribution paid or payable (whether or not in money and whether described as a refund, rebate, price adjustment, or payment of a balance due under a marketing agreement) to member patrons or to member and nonmember patrons on some basis related to their sales to, purchases from, deposits with, investments in, loans from, or other transactions with the corporation during the taxable year, if (A) the allocation or distribution is conditional (i) upon profits or margins being earned by the corporation from all its operations or a class of its operations during its fiscal year, or (ii) upon income attributable to the resale of the producer's product along with products or a class or classes of products of some other producers less any deductions, determination of which is within the discretion of the corporation, or (B) the amount of the allocation or distribution can be determined only with reference to the amount of the profits, margins, or income earned, or (C) the amount of the allocation or distribution can be determined only after declaration or payment of dividends on any class of stock of the corporation or only after the fixing of sums to be transferred to capital, reserve, or surplus."

(c) The table of sections for such part IX is amended by adding at the end thereof the following:

"Sec. 280. Patronage dividends paid by
cooperative corporations."

Sec. 3. DEFINITIONS OF DIVIDENDS.

(a) Section 116 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following new subsection:

"(e) PATRONAGE DIVIDENDS.--The term 'dividends' as used in this section includes patronage dividends, as defined in section 280(b), received after December 31, 19 , and payable with respect to transactions during a taxable year beginning after December 31, 19 ."

(b) Section 243 of such Code is amended by adding at the end thereof the following new subsection:

"(e) PATRONAGE DIVIDENDS.--The term 'dividends' as used in this section includes patronage dividends, as defined in section 280(b), received after December 31, 19 , and payable with respect to transactions during a taxable year beginning after December 31, 19 ."

Sec. 4. DIVIDENDS RECEIVED: EXCLUSIONS AND DEDUCTIONS.

(a) Section 116(b)(2)(A) of the Internal Revenue Code of 1954 is amended by striking out "or section 521 (relating to farmers' cooperative associations)".

(b) Section 246(a)(2)(A) of such Code is amended by striking out "or section 521 (relating to farmers' cooperative associations)".

Sec. 5 MISCELLANEOUS CHANGES.

(a) Section 3121(b)(10) of the Internal Revenue Code of 1954 is amended by striking out "or under section 521".

(b) Section 3306(c)(10) of such Code is amended by striking out "or under section 521".

(c) Section 4382(a)(3) of such Code is hereby repealed.

(d) Section 4421(2)(B) of such Code is amended by striking out "sections 501 and 521" and inserting in lieu thereof "section 501".

(e) Section 6072 of such Code is amended by striking out subsection (d) and by redesignating subsection (e) as subsection (d).

Sec. 6 TAXABLE YEARS TO WHICH APPLICABLE.

The amendments and repeals made by this Act shall be applicable only with respect to taxable years beginning after December 31, 19 .

TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE

Hearings on the Administration's Tax Package

March 16 - 19, 1982

Submitted by:

C. WILLIAM CARTER

Vice President - Operations
Long Lake Energy Corporation
330 Madison Avenue
New York, NY 10017

Mr. Chairman and members of the Finance Committee, thank you for allowing us to submit the views of Long Lake Energy Corporation at your hearing on the Administration's Tax package. We are extremely concerned about the potential elimination of the Safe Harbor Lease provision in the 1981 Economic Recovery Act. New companies such as Long Lake, that are developing renewable energy resources are relying heavily on the financial opportunities opened up by the passage of the Safe Harbor Lease provision. If this provision is not continued, it will not be economical for companies such as ours to develop the full potential of this Country's renewable energy resources.

Long Lake Energy Corporation is a private firm developing small-scale hydroelectric projects in New York State. We have played a catalytic role in the development of hydroelectric energy in New York State. In the past 12 months, Long Lake has filed 39 permits and 19 licenses. FERC has just issued two licenses to us and we hope to receive several more in the near future.

The next steps in the development of these hydro resources are signing contracts with utilities and securing financing for the projects. Our ability to obtain financing and to continue in this business will be heavily influenced by upcoming actions by Congress and the Administration. There are many renewable energy companies that are at a critical stage in their development.

If these new industries are to successfully develop renewable energy resources, there must be a stable investment climate. As we have experienced in our recent dealings with bankers, even the threat of changes in the laws can make investors reluctant to finance our projects. Every effort should be made to stabilize the laws and regulations impacting this developing industry.

The passage of the Economic Recovery Act of 1981 eliminated a significant obstacle that small power producers such as Long Lake faced. The development of small-scale hydro projects requires a long lead time. It can take 6 to 18 months to obtain a license and 1 to 2 years to order equipment and complete construction. During this time, the company receives no revenue from its projects and it operates at a loss. As a result, the company cannot utilize tax credits and accelerated recovery that it is eligible for.

The value of these credits is not an insignificant amount especially for new companies such as ours. The credits can equal 10 to 50% of the net return from a project. Obviously, without the ability to transfer the value of the credits to profit-making companies that can take advantage of them, many hydro projects will no longer be viable. This is true for companies developing other renewable energy resources as well.

The Safe Harbor Lease provision provides a simple, efficient mechanism for transferring the value of the tax credits and accelerated recovery from one company to another. The elimination of the Safe Harbor Lease provision will discourage entrepreneurs from taking the risks involved in setting up new renewable energy companies. It will be much more difficult for these new companies to participate equitably in the distribution of benefits. This runs counter to the Administration's and Congressional efforts to encourage competition and economic development. We urge this Committee to insure that the renewable energy companies (as defined as Qualified Energy Property in Section 48(c)(8)(F)(iii)) continue to be eligible to use the Safe Harbor Lease provision.

If the Committee has any questions, we would be happy to answer them.

KAISER
CEMENT

KAISER CEMENT CORPORATION, KAISER BUILDING, 300 LAKESIDE DRIVE, OAKLAND, CALIFORNIA 94612

March 17, 1982

The Honorable Robert J. Dole, Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Senator Dole,

Kaiser Cement Corporation, a U.S. cement producer since 1939 and currently the largest producer in the Western States, appreciates this opportunity to describe to the Senate Committee on Finance some significant developments which are occurring regarding the use by port authorities of their tax-exempt status to subsidize the importation of foreign products in competition with domestic manufacturers. These developments affect the health and continued viability of an industry which provides an essential ingredient to at least 90 percent of all construction projects and which is, therefore, absolutely vital to the U.S. construction sector, which is itself the sixth largest industry sector in the United States.

Since 1979, three import terminals for bulk cement have begun operations in California, at the Ports of Long Beach, San Diego and Stockton. A fourth terminal is pending approval by the Port of Redwood City. Together, these terminals will have the capacity to handle approximately 1,750,000 tons of imported cement annually. This potential volume is equivalent to 13.4 percent of the rated capacity of all California cement manufacturers and more than 24 percent of the cement actually shipped in California last year.

In the case of the proposed terminal at Redwood City, the port authority reportedly intends to finance a substantial portion of the variously estimated total cost of $8 - $24 million with tax-exempt industrial revenue bonds. Although tax-exempt bonds were apparently not used for the Stockton and San Diego projects, we believe that these facilities were financed out of the tax-exempt operating revenues of these respective public port authorities. Moreover, in the case of the Port of Long Beach, tax-exempt bonds were used to finance other projects, so that internally generated funds were available to finance the $17 million cost of its bulk cement terminal.

The establishment of these import terminals is occurring at a time when the cement industry in California is operating substantially below full capacity but is nonetheless spending hundreds of millions of dollars to modernize and expand its manufacturing facilities. Kaiser Cement alone has committed almost $250 million to improve the cost-efficiency, modernize and enlarge the capacity of its California plant. In 1981, the cement industry in California added nearly 1.7 million tons of annual capacity. By 1984, the industry is expected to add another 1.3 million tons of annual capacity. Nearly all of this new capacity will employ the most fuel-efficient technology available.

In general, we believe that the public interest is not served by permitting port authorities to use tax-exempt bonds to subsidize the importation of foreign products in competition with domestic manufacturers. Our reasons are as follows:

1. It is patently unfair to provide foreign importers unlimited financing at below market rates, for facilities to handle their products, when similar financing is not generally available to domestic manufacturers. Although it is desirable to promote international trade, this should be accomplished through the removal of artificial trade barriers, not through the creation of taxpayer-financed subsidies which accord foreign importers an unfair competitive advantage.

2. To the extent that interest subsidies induce imports that would otherwise not be profitable, they cause an uneconomic allocation of capital resources. While ports and port communities may initially benefit from the resulting increase in trade, domestic manufacturers will suffer an immediate loss of sales and an eventual decline in investment and employment. As manufacturing plants are typically more capital and labor-intensive than import facilities, any loss of their natural markets to imports will have a disproportionately adverse affect upon the domestic economy and particularly upon employment in those natural markets.

3. The promotion of imports through interest subsidies undermines the President's program to stimulate business investment and improve productivity. Any artificial inducement for imports contributes to lower operating rates and returns on investment for domestic manufacturers. When domestic markets are over-supplied, the needed flow of capital funds into improved plant and equipment is likely to be retarded or inhibitied.

4. The substitution in the marketplace of subsidized imports for domestically manufactured products is likely to result in a net reduction in tax revenues. Because much of the profit on imported products is realized by foreign suppliers and shippers, the amount retained by the importer subject to tax in the U.S. can be modest, compared to that earned by a domestic manufacturer. Thus, in fact and effect, Federal taxpayer subsidization of import facilities is not being used for a legitimate public purpose. Rather, such use results in loss of domestic business revenues and a corresponding loss of tax revenue to the Federal and state governments.

5. Although port facilities financed by tax-exempt bonds are required to be public in nature, they can be essentially single-purpose facilities for the exclusive use of an importer, because of design limitations or the lack of suitable alternative users. Such is the case with several of the cement import terminals referred to above.

Interest subsidies made available to foreign importers through port authorities are unfair and unnecessary to promote legitimate international trade. At worse, they enable marginally profitable importers to enter domestic markets as a result of their unfair advantage in obtaining financing at below market rates. The modest benefits obtained by a particular port and its local community do not adequately compensate for the long-term injury suffered by domestic manufacturers and the U.S. economy.

We recommend that Congress consider developing more explicit rules for assuring that tax-exempt financing can be used only for truly "public" import facilities, and rules that require the port authority to demonstrate that facilities so financed will not result in a loss of jobs in the community generally to be served by the imported products.

In conclusion, we wish to underscore that Kaiser Cement Corporation does not oppose rigorous and fair competition between domestic-producted and foreign-produced cement or other products. We do object, however, to the subsidization of foreign goods by the American taxpayer

We respectfully request that this statement be included in the Committee's hearings.

Very truly yours,

Walter E. Ousterman, Jr.

Walter E. Ousterman, Jr.
Chairman of the Boartd, President and
Chief Executive Officer

REPUBLIC GEOTHERMAL, INC.
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SANTA FE SPRINGS, CALIFORNIA 90670

JAMES R. STITES
SENIOR VICE PRESIDENT

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STATEMENT OF JAMES R. STITES, SENIOR VICE PRESIDENT
REPUBLIC GEOTHERMAL INC.
PREPARED FOR
SENATE COMMITTEE ON FINANCE
March 12, 1982

My name is James R. Stites and I am Senior Vice President of Republic Geothermal, Inc., a company engaged in the exploration, development, production and marketing of geothermal resources. I appreciate this opportunity to supply, for the Committee's hearing record, a statement by Republic Geothermal expressing its views on the Administration's tax proposals. In particular, Republic would like to comment on the proposal of the Administration to repeal the energy investment tax credits.

First, I would like to thank this Committee for its strong and consistent support of the energy investment tax credits and the alternative energy industry. You have demonstrated, most recently by your letter to the President urging retention of the tax credits, an understanding of how vital these credits are for the success of non-oil and gas energy development in this country. Without question, the energy tax credits are the major factor in the remarkable progress achieved in the renewable resources sector in general, and in the geothermal area in particular. Repeal of the geothermal tax credits will cripple or cause the demise of the geothermal industry. You can be sure that we will follow your lead in working to see that these important incentives remain in place. I can assure you that your support is very much appreciated.

We find the Administration's reasoning for the repeal of the energy tax credits to be faulty and misfounded. Other tax incentives, enacted as part of the ERTA of 1981, although greatly improving the business atmosphere, do not go far enough in attracting capital to our industries. Nor can we understand the revenue estimates we have seen with regard to collections which would occur if the energy investment tax credits were repealed. Recent studies have shown that the cost of the energy investment tax credits to the Treasury is offset by energy savings. And, under some very reasonable scenarios, Treasury will actually profit on the energy tax credit program by increased corporate revenues. Moreover, substantial federal royalties for geothermal resource production, stimulated by the energy tax credits, will accrue to the Treasury for geothermal energy development on the numerous federal leases.

If anything, we would argue that the energy investment tax credits should be increased to encourage this source of alternative, non-oil and gas production. While the fossil fuel market may now be soft, we at Republic do not feel that this country should lull itself into a false sense of security, even for the short term. If projects are now abandoned, it will take over a decade to start them up again and the U.S. will suffer the consequences. For a very minimal outlay we can continue to guard against events which are, to a large extent, beyond the control of our country.

The commercial development of geothermal resources is capital intensive, characterized by high-up front capital costs, offset by low running costs over a long operating period. A typical geothermal project will take four to five years to complete after the geothermal resources which constitute a commercial prospect have been identified. Accordingly, you will easily understand why the geothermal industry needs the maximum tax credit to attract investors to a technology which is relatively new and thus perceived, by some investors, as risky, and which takes a considerable period of time to develop. For the same reasons, the present 1985 expiration date for the geothermal tax credit is too short and should be extended. And, of great importance, at this time, is the necessity for so-called "affirmative commitments" language similar to that contained in Senator Wallop's bill, S. 750. That bill quite appropriately extends the affirmative commitments time-table through 1994 for certain non-renewable energy property. Few people recognize that there is no existing affirmative commitments section for certain other types of property, including geothermal property. Yet, in light of the constant attacks on the energy investment tax credits, and in view of the heavy capital commitments required, it is essential that, for these long lead time projects, we have the security of knowing that these projects, once undertaken, will be completed within the economic framework upon which we embarked.

We would also like to comment briefly on the controversial, so-called "safe harbor" leasing provisions. We understand problems associated with safe-harbor leasing techniques and likewise recoil at the excesses reported. But the concept of transferability of tax incidents is absolutely valid in particular situations, and the neophyte alternative energy industry presents perhaps the most meaningful of these situations: difficulty in attracting capital, inability to make use of investment tax credits until profitable, and commitment to efforts which are, without question, in the national interest. Here, if anywhere, new industries should be able to transfer their tax credits to successful industries who can thus help underwrite new, emerging alternative energy sources.

Finally, we would like to share with you the difficulties, in practice, of utilizing the energy tax credits which you have fashioned. The Internal Revenue Service has taken an unduly stringent and restrictive interpretation of the energy tax credits. For example, we were stunned to learn that equipment used to drill for and produce geothermal energy was excluded from eligibility for the geothermal tax credit by IRS regulations issued in January, 1981, well after the enactment of the 1981 credits. Such equipment is fundamental to the production of geothermal energy and, we believe, was clearly intended to be eligible for the geothermal tax credit. This is merely one example of the type of obstruction posed by the Internal Revenue Service in its interpretation of the credits.

As an example of the broader questions on effective application of the tax credits, we would urge you to look at how we can best market our technology overseas which would help lessen other countries' dependence on imported oil and make our citizens the beneficiaries of lower prices based on mass production and marketing. In this regard, we invite your attention to the restriction against any property used predominantly outside the United States from qualifying for the investment tax credit. Thus, although a contractor may export important technology and "know-how", in the implementation phase, he is discouraged from taking the tools of his trade abroad. This works against our twin goals of stimulating the economy and rectifying our now chronic negative balance of payments. Particularly in the emerging geothermal energy area, expanding the markets to include such property would dramatically reduce overall costs and further implement our national energy policy.

In closing, let me again thank you for your leadership and support in the alternative energy area. We believe that the energy tax credits have made the difference and that they have been instrumental in nurturing our fledgling geothermal industry. We implore you to stand with us once again and insure that these energy investment tax credits remain intact and, indeed, are improved and made more viable. We look forward to working with you in the future.

AMERICAN IRON ORE ASSOCIATION
STATEMENT TO THE COMMITTEE ON FINANCE

Hearings on Tax Proposals in the Administration's Budget
(March, 1982)

The American Iron Ore Association is a trade organization representing companies that mine approximately 75% of the iron ore produced in the United States and Canada, as well as a substantial amount of iron ore produced in the free world. Not having been selected for an oral presentation at the hearings, this statement is being submitted for the record in response to Chairman Dole's February 12, 1982 announcement of hearings related to various aspects of the Administration's budget proposal. Specifically, we are addressing the tax revision proposals which were released by the Department of Treasury on February 26, 1982.

The Present Environment and Economic Conditions

The Reagan Administration is presently under severe attack by some critics, both in and out of government, who would enjoy nothing more than to see its economic policies fail. The American Iron Ore Association is not to be identified with this segment of the population. We firmly agree with the Administration's assessment that government spending has gotten out of hand and that many involvements and "entitlements" of government have grown much too large.

Inflation has been labeled the cruelest tax of all, but it doesn't get attention through negative publicity because of its impersonal nature. President Reagan's economic program of 1981 is aimed at government excesses and inflation. We remain convinced that the program will bring positive results to our entire economy and to all citizens, but a redirection of government this vast cannot possibly be evaluated as to its effectiveness within six months after being put in place. We ask that you not permit the present dialogue and confusion over federal deficits to lead to tampering with the substance of the 1981 economic program, of which business taxation is only one element.

The American Iron Ore Association is not unmindful of our country's present fiscal situation, and it sincerely appreciates the anxiety of those who believe the anticipated deficit for the upcoming fiscal year will be excessive or will lead to even greater continued deficits in subsequent years. On the other hand, we strongly oppose this hastily developed new approach by the Administration to impose substantially higher taxes on capital intensive business, and we question the justification for legislation to increase income taxes by any means at this particular time. However, if it is subsequently determined that there is a substantiated need for additional income tax revenues, we ask that permanent legislation be directed toward identified and valid problem areas and that any interim solution be chosen very carefully and be temporary in nature.

During 1981, when the Administration's economic program was being debated, iron ore and steel companies were in a definite economic slump. As we've moved into 1982, economic conditions have worsened; and our industry is now suffering from the largest and most extended cutback in demand for its products in the last quarter century. But, we do not attribute our present economic tribulations to the recently enacted and instituted programs of the Administration. It is clear to us that this country and our industry now have an international problem of immense proportions. In this regard on an even broader scale we also believe that a nation which seems to have an insatiable demand for, and an ability to consume, leisure-time activities, while its basic industries and natural resource capabilities are faltering, should be raising some fundamental questions about its overall sense of direction.

Last Year's Support of the Administration's Economic Program

In 1981 the American Iron Ore Association submitted written statements to your committee and to the Committee on Ways and Means in connection with the President's economic program and tax reduction proposals. Our organization strongly supported the Administration's 1981 economic package which called for a significant reduction in federal spending, coupled with a reduction of individual income marginal tax rates across-the-board over a three-year period and the establishment of the Accelerated Cost Recovery System. We commend the Administration and the Congress for their determination in establishing these initiatives through bi-partisan legislative effort, and now that implementation has begun we remain of the firm view that these actions, if left in place and substantially intact, will prove to be of vital assistance in helping to satisfy our nation's desperate need for improved productivity and increased rates of savings and investment.

Our statements for the hearings record in 1981 also supported the Administration's original request for a "clean" tax bill to be followed by a second bill of broader latitude, and we expected that any such considerations of consequence would be the object of a further hearings process. As it turned out, the single major piece of tax legislation that sprung forth in 1981 in the form of the Economic Recovery Tax Act contained a variety of significant and far-reaching provisions that were not directly the subject of the public hearing process. Before speaking directly to this year's considerations, we wish to say that the hearings procedure of 1981 should not serve as the model for consideration and enactment of important new tax legislation in the future.

An Uncertain Tax Atmosphere is to be Avoided

Throughout the past decade, there has been an increasing trend toward instability in our federal tax system. This ever-present lack of certainty has serious negative implications on any sound business decision-making process. Now, with the Administration proposing significant new tax legislative proposals just six months following the enactment of the Economic Recovery Tax Act of 1981, we seem to have reached an all-time high for instability in the tax legislative process. We view the present situation of having to deal with a policy reversal proposal in early 1982 with deep reservations and skepticism.

The Proposed Minimum Tax on Selected Business Deductions Has Many Serious Shortcomings

Many of the member companies of the American Iron Ore Association have been adversely affected by the present add-on minimum tax for corporations. In testimony of several prior years, this organization, in calling for repeal of the minimum tax, has pointed out the onerous impact this tax has on corporate enterprises carrying on iron ore mining operations in terms of its drain on capital formation and needed cash flow. With present economic conditions in our industry worsening daily and an increased need to dispense with the ill-conceived tax on tax deductions, we are at a loss to understand the reasoning of the Administration in suggesting a new alternative minimum tax which would be even more burdensome to our member companies. Although we do applaud the Administration for suggesting a repeal of the add-on minimum tax, we certainly cannot subscribe to a more onerous minimum tax in its place. (We are not submitting quantitative data as to the adverse consequences of the Administration's proposal on our membership because, for the most part, it would constitute duplication of amounts included in the several hundred million dollar total which has already been communicated in testimony by other organizations representing the mining and steel industries.)

The construction of the Administration's alternative minimum tax proposal is of the "quick fix" variety, overriding and substantially diminishing by an indirect formula approach a wide variety of selected provisions of the existing Internal Revenue Code (i.e., net operating losses, investment credits, foreign tax credits, and the chosen "bad" deductions such as mine development). Furthermore, we see in the Administration's proposal an attempt to sanctify an aberration of corporate business taxation. No substantiation has ever been advanced to support the taxation of corporate tax deductions. The add-on minimum tax came into law in 1969 without benefit of a full hearing process as a by-product of the drive to insure payment of some tax by a few high income individuals who reportedly had been successfully sheltering substantial amounts of income from tax. Likewise, there has never been substantiation advanced to support the arbitrary 15% rate which was established in 1976 as an increase from 10%, which also never had been the subject of rational explanation.

The American Iron Ore Association supports the proposition that all entities with economic income should pay some tax, but it virgorously challenges any implication that our opposition to the Administration's alternative minimum tax proposal (or to tne existing add-on minimum tax statute for that matter) constitutes a rejection of that proposition. In reality, the Administration's proposal reaches far beyond the taxation of economic income, and it is this overextension that causes us difficulty. It certainly is obvious that the Administration did not attempt to define economic income, and it appears as though there was no independent consideration given to the proper rate or rates of taxation to be applied thereto in the few short weeks from the President's announcement of the intended "strengthening" of the minimum tax in his State of the Union message in January to the Treasury Department release in February.

In addition to the promotion of an ill-founded concept for taxation, the Administration's proposal creates an unnatural and undesirable setting for controversy. This is an extremely serious problem in our estimation. Rather than focusing upon the aspects of existing tax law which are deemed worthy of review, your committee's attention is being focused on so-called "preferences" and a new form of tax complexity which will extract under a new scheme substantial revenues from many corporations with unlucky facts under a new and different set of standards. If various business interests are enticed into defending particular "preferences" being suggested for taxation, should it be implied that the concept itself and the rate are acceptable? If no such defense is advanced, does this establish the worthiness of any particular item as a "preference"? We believe the answer to both questions is emphatically no, but we still feel obliged to point out that the Administration's proposed treatment of net operating losses and investment credits from prior years and the identification of mine exploration and development as a "preference" are completely indefensible and grossly inequitable. These three aspects and the inherent permanence of the concept would cause the greatest resistance to the tax, even if the need for tax revenues at this time could be justified. Moreover, the stacking of "tax preference" items upon the income of foreign branches discriminates in favor of those who conduct their business through foreign subsidiaries. We believe that discrimination in this manner encourages the incorporation of foreign branches into foreign subsidiaries and, therefore, is not sound tax policy.

In summary, we are troubled to find that the present Administration has come under such extreme criticism and premature pressure with regard to recently enacted capital formation incentives that it has abruptly and prematurely seized upon this ill-founded minimum tax proposal. Considering the relatively minor impact on Treasury revenues, coupled with the dramatic, misdirected and inequitable increase in tax cost to certain capital intensive mining corporations, it is not possible for us to understand the rationale. What seems to have been forgotten is that this country's basic industries have been engaged in an economic war with their foreign competitors and that the Economic Recovery Tax Act of 1981 has provided assistance in overcoming a serious international disadvantage. The Administration's 1982 proposal would again deprive many capital intensive industries of this long-awaited economic stimulus. If the private enterprise system is to survive and prosper in the face of competition from nationalized and foreign government supported competition, this country must continue to provide the mining and basic industrial segments of our economy with necessary tools through an economically viable income tax system.

Cash Flow from Capital Cost Deductions and Investment Credit Utilization is Vital

In 1981, the statement submitted to your committee by this organization pointed out that substantial expenditures by our member companies, which were undertaken in recent prior years for plant expansions, modernizations, and governmentally mandated expenditures, had given rise to an accumulation of unused investment credits. At that time we observed that depressed earnings were also restricting the utilization of these available credits, and we called for a program in which credit utilization might be enhanced, at least for the short term.

As is generally known, "safe harbor leasing" was ultimately enacted in 1981 as a means by which newly created credits and capital cost deductions can give rise to immediate cash flow in the current year, thus avoiding further build-up of unused balances. Now that Congress has selected this vehicle to help generate cash where capital investment is taking place, we recommend that its basic elements remain intact long enough to permit adequate evaluation of its effectiveness. We have no reason as yet to think that this general type of legislation is not already serving the intended purpose of stimulating the movement of funds toward investment in needed production facilities, and we strongly advise against impulsive and exaggerated negative reactions in this area of tax legislation. It should also be observed that in future years under existing tax law it is extremely unlikely that there could occur a repeat condition of 1981, whereby such large amounts of unused credits that had accumulated over so many years were backed up and unutilized.

Also, without question, self-use of tax credits and deductions will always be economically preferable whenever income is adequate, so it is predictable and understandable that the tide of "safe harbor leasing" will never again rise to the level already reached since passage of the 1981 Act. If it ever does, it will most likely constitute an indication of very severe economic hardships throughout the economy with implications extending far beyond the tax code. Certainly, there must be initial close scrutiny of this and any other tax legislation of such magnitude and importance, and it is quite likely that modifications and/or fine tuning may be necessary now to curb abuses and to insure that the intended purpose is being fulfilled in all cases; but it seems much too early for there to develop a wholesale loss of faith in its usefulness.

Other Proposals by the Administration

The American Iron Ore Association is not as perplexed about the remaining tax revision proposals announced by the Treasury on February 26, although we do question some of the expressed reasoning with regard to certain items; but we must reiterate our conviction that, overall, this hasty initiative to raise business taxes in 1982 legislation on a broad scale (primarily from capital intensive industries) is both unwarranted and unsettling to us, especially so soon following the 1981 enactment.

aamc association of american medical colleges

March 9, 1982

Honorable Robert J. Dole
Chairman
Finance Committee
United States Senate
2213 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

According to its Fiscal Year 1983 budget request, the Administration intends to soon put before you a legislative proposal designed to restrict significantly the use of federal tax-exempt revenue bond financing. Some of the provisions under consideration would virtually terminate the availability of such financing to non-federal, not-for-profit hospitals. For these public purpose institutions, tax-exempt financing now is the source of well over half of their construction capital. On behalf of the membership of the Association of American Medical Colleges (AAMC), I wish to express several concerns regarding this Administration proposal and request that pursuit of this course of action be rejected by you and your Congressional committee colleagues.

The Association's constituency includes all of the nation's medical schools, 74 academic societies, and more than 325 non-federal, not-for-profit hospitals. These hospitals participate in the Medicare program; account for sixteen percent of the admissions and twenty percent of the ambulatory services provided by non-federal short-term hospitals; provide a comprehensive range of patient services, including the most complex and intensive tertiary care services; and are responsible for a majority of the nation's medical education programs. Moreover, these hospitals account for 35.4 percent of the patient bad debt deductions and nearly half of the charity care deductions at all short-term community hospitals in the United States. Thus, a proposal that would limit the federal tax exemption for interest on private, nonprofit hospital bonds is of direct and vital interest to the AAMC, its members, and the communities and publics they serve.

NO EVIDENCE LINKING TAX-EXEMPT FINANCING TO HOSPITAL OVERBEDDING

Previous efforts to restrict the availability of tax-exempt hospital bonds have been based on the assumption that a causal relationship exists between the use of such financing and the construction of unneeded hospital beds. Treasury Secretary Regan's discussion of the misuse of industrial revenue bonds to build "unneeded hospitals and hamburger stands," which appeared in the January 12, 1982 New York Times, leads one to believe that the current Administration believes similarly.

The AAMC contends that there is no evidence which supports this assumption. In fact, according to the Bureau of Census' own figures, annual completed hospital construction dropped 35 percent between 1971 and 1979 when measured in constant (1967) dollars. Inversely, for the same time period, the

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Congressional Budget Office (CBO) reports that the volume of hospital tax-exempt bonds issued rose 672 percent. Thus, despite the rapid increase in hospital tax-exempt bond use, hospital construction in real dollars declined, strongly contradicting the assumption of a positive correlation between the two.

In addition, the vast majority of hospital construction projects are undertaken specifically to replace or renovate antiquated, inefficient and substandard facilities and equipment, or to convert existing facilities in response to evolving medical practice and patient demand patterns (e.g., transforming inpatient facilities into ambulatory care units). These are necessary and legitimate projects which require capital, but add no new beds to the existing health care delivery system. According to the American Hospital Association's Hospital Construction Survey, only 28.4 percent of hospital capital projects undertaken in 1978 were for new construction. Clearly, the premise that tax-exempt hospital financing invariably results in more beds is erroneous.

EFFECTIVE GOVERNMENTAL AND MARKETPLACE MECHANISMS TO MONITOR THE NEED FOR HOSPITAL CAPITAL EXPENDITURES EXIST

As it argued in its comments on a restrictive proposal made by OMB under the previous Administration, the Association believes that any arbitrary legislative plan to limit tax-exempt financing for hospital capital projects would lead to an inappropriate role for the federal government in the capital marketplace. It would also ignore existing federal health planning authority, and many state regulatory agencies, responsible for monitoring need for major capital expenditures by hospitals.

Under the various Certificate Of Need (CON) review provisions of the National Health Planning Act (P.L. 93-641) and its amendments (P.L. 96-79), Health Systems Agencies (HSAs) and State Health Planning and Development Agencies (SHPDAs) are required to certify the need for capital expenditures, major medical equipment acquisitions, and new institutional health services proposed by hospitals. These decisions must be based on such criteria as the appropriateness of the costs and methods of proposed construction, the application of national guidelines which include a standard for overbeddedness, and the impact on patient care costs and charges at the proposing institution and other area facilities.

Tax-exempt bonds are purchased by private investors in competition with other investment opportunities and are therefore subject to the self-regulating investment market. To limit their risk and assess a hospital's debt repayment potential, investors have historically conditioned their purchase of tax-exempt bonds on CON approval of projects. The certificates are viewed as expressions of community need, economic soundness and the will of the people. These principles have also been of primary importance to state bond issuing authorities in their determinations to approve or deny tax-exempt financing for hospital projects.

In the absence of evidence to support the assumption of a linkage between the availability of federal tax-exempt hospital financing and construction of excess hospital beds, the Association recommends that the federal government maintain its current policy on tax-exempt hospital bonds. It must not attempt to displace the combination of local level decision-making and consumer choice with some form of arbitrary federal statutory proscription and new burdensome regulation.

THE TREASURY'S ESTIMATED REVENUE LOSS DUE TO TAX-EXEMPT HOSPITAL BOND ISSUANCES IS OVERSTATED

The Association respects the Administration's efforts to identify new revenue sources to offset the burgeoning federal budget deficit. However, it must take issue with CBO's current projections of $100 million, $200 million, and $300 million in Treasury revenue losses due to new tax-exempt hospital issues for Fiscal Years 1982, 1983 and 1984 respectively. These estimates are believed to be overstated because:

- o they fail to account for the reduced federal Medicare and Medicaid reimbursement outlays attributable to the lower interest expenses of tax-exempt financed hospitals;
- o they fail to account for increased personal and corporate tax revenues paid by hospital employers and contractors; and
- o tax rate reductions enacted in the Economic Recovery Act of 1981 will reduce the cost of tax exemptions to the government and the loss of Treasury revenue in turn.

Thus, the AAMC strongly opposes the limitation of federal tax-exempt hospital financing as an overestimated response to the dubious premise that such financing contributes significantly to excess hospital bed capacity and federal government expense.

TAX-EXEMPT FINANCING FOR NON-FEDERAL NOT-FOR-PROFIT HOSPITALS IS BOTH APPROPRIATE AND NECESSARY IN THE PUBLIC INTEREST

Non-federal not-for-profit hospitals are an essential component of our nation's health care system, serving an undeniable public purpose. The vast majority of teaching hospitals in the U.S. belong to this hospital group and provide vital and highly complex patient services, often at no charge to the poor and medically indigent. Additionally, these institutions serve society through their education and research missions which advance biomedical science and technology and supply the nation's health manpower. The proper maintenance and continuing viability of these institutions depends upon their success at capital formation.

Eliminating or restricting significantly the tax-exempt status of hospital bonds would prevent financially weaker institutions from undertaking necessary improvements and would raise considerably the cost of borrowing capital to more financially stable hospitals (and thereby also increase the federal and state level reimbursement claims of these institutions). The federal government's reimbursement policies under the Medicare and Medicaid have had a prohibitive effect on not-for-profit hospitals as well. These policies tend to cover less than the full costs of operation for these hospitals and deny them a return on equity accorded proprietary institutions. Moreover, recent legislative amendments have further reduced federal reimbursement. This has taken its toll disproportionately on the revenue of not-for-profit institutions, and teaching hospitals particularly, because they serve proportionately more Medicare and Medicaid patients.

As a result, the not-for-profit hospitals are rapidly consuming all their own available capital raised through earnings accumulation and charitable contributions and are assuming more and more debt to acquire financing.

Because they do not pay income tax and receive no benefits from tax incentives (e.g., investment tax credits or deduction of interest expense), not-for-profit institutions view the tax-exempt financing mechanism as a means of making their borrowing costs comparable to those of proprietary hospitals. Should this mechanism be terminated or curtailed seriously, many of the financially weaker, though essential, hospitals would be forced to join the sizable group of urban and rural hospitals that are operating on the fringe of insolvency.

Furthermore, it must be recognized that the nation's health care delivery system is an integrated and interdependent one. Impairing the ability of not-for-profit institutions to adequately meet community needs and maintain public health will adversely affect, and in many instances irreversibly strain, the capabilities of other public and private hospitals in the country that would have to assume greater responsibility as demand for health services is shifted to them. An erosion of the quality of care in the system inevitably would follow.

CONCLUSION

In summary, the AAMC strongly urges the federal government to maintain its present policy regarding hospital use of federal tax-exempt bonds and discontinue activity to adopt a legislative proposal that would limit such bond use. This recommendation is based on the following grounds:

(1) There is no evidence linking tax-exempt financing to hospital overbedding.

(2) Governmental and marketplace controls exist to monitor the need for hospital capital expenditures and need not be displaced or duplicated.

(3) The Treasury's estimated revenue loss due to tax-exempt hospital bond issuances is overstated.

(4) Tax-exempt financing for non-federal, not-for-profit hospitals is both appropriate and necessary in the public interest.

I appreciate this opportunity to express the Association's concerns and suggestions on the issue of federal tax-exempt hospital financing and hope they will be considered seriously in your deliberations in the days ahead. I, and members of the AAMC staff, would be pleased to discuss these matters further with you at any time.

Sincerely,

John A.D. Cooper, M.D.

WRITTEN TESTIMONY OF
PRESIDENT TERRY SANFORD
DUKE UNIVERSITY
ON TREASURY DEPARTMENT'S TAX PROPOSALS
SUBMITTED TO THE SENATE FINANCE COMMITTEE

MARCH 17, 1982

Like the presidents of other universities, I am concerned that one of the Treasury Department's proposals for revising the tax code would seriously damage the capacity of our country's institutions of post-secondary education to deliver instruction and research of the highest quality.

In the attempt to control the proliferation of certain tax-exempt revenue bond issues (industrial development bonds in particular), the Department's proposals would restrict universities' use of bonds vitally needed for facility construction and student loans. The Treasury Department proposes that tax-exempt financing be limited to bonds approved by local governments and, after 1985, bonds receiving a financial contribution or commitment from the local government. These requirements would do more than simply reduce the abuse of tax-exempt industrial development bonds issued for private purposes of for-profit corporations: as a practical matter they would also unnecessarily eliminate all student loan bonds and virtually all 501(c)(3) bonds for capital borrowing.

Duke anticipates using tax-exempt financing for constructing long-overdue housing for our students, completing our business school facility, developing an automated energy management and conservation system, and purchasing computers and other facilities we critically need to continue our research efforts. Like almost all colleges and universities we also must plan for the financing of the great accumulation of deferred maintenance on our plant and equipment, a task involving large sums of capital.

These tasks embody the traditional kinds of public purpose activities which are required as a precondition to exempt status under Section 501(c)(3) of the tax code. As public purposes they reflect the very objectives for which tax-exempt financing is intended. It distorts reality to suggest in any way that the tax-exempt financing of 501(c)(3) organizations serves private purposes. The Duke Hospital, for example, which we constructed using tax-exempt bond financing, will provide $82 million in Medicaid, Medicare, and charity care this year--48% of its total budget; the balance of its activity still exclusively involves health care, a charitable or public purpose.

Small-issue IDBs accounted in 1981 for almost half of all non-government-issued tax-free bonds, and about one quarter of the entire long-term tax-exempt bond market. These are clearly "private purpose" issues; by contrast, higher education facility construction and student loan bonds, and their associated revenue losses, constitute only a fraction of small-issue IDB volume. If the Committee deems it advisable to restrict the use of tax-exempt bonds, it seems clearly possible and desirable to preserve tax exempt bond authority for the charitable and public purposes of 501(c)(3) organizations, including universities and their teaching hospitals. Although small compared to other kinds of issues, these bonds provide a crucial part of our shrinking financial base and should not be eliminated.

Even as the Administration calls for the private sector--especially charitable institutions--to replace the federal government in activities vital to our country's cultural, economic, and technological development, we find our capacity to meet that challenge undermined. Proposals to severely reduce financial assistance threaten our best students--including essential young research scientists. And, as we are learning through our experience with the effects on charitable giving of the Economic Recovery and Tax Act of 1981, tax changes can cause serious unforeseen harm to important but vulnerable enterprises like ours.

I urge the Finance Committee to exempt 501(c)(3) institutions' bond issues and student loan bonds from the Treasury Department's legislative proposals.

CITY OF OCEANSIDE
OFFICE OF THE CITY MANAGER

Testimony of Philip L. Millenbah, Energy Coordinator, City of Oceanside, California to the United States Senate Committee on Finance. Testimony supports continuation of the 15% Business Energy Investment Tax Credit.

Member's of the Committee:

The City of Oceanside, California has created a Municipal Solar Utility (MSU), the goal of which is to reduce dependence on fossil fuels and local utility bills - which are amongst the highest in the Country - for its residents.

A principle element of Oceanside's Municipal Solar Utility is the Solar Leasing Program that combines private sector investment capital with public sector involvement. This Solar Leasing Program has been developed as a prototype for other California cities, and cities throughout the nation. Some of the cities working with Oceanside in developing their own Solar Leasing Programs are:

City of San Diego, California
County of San Diego, California
City of Monterey Park, California
City of San Jose, California
City of Del Mar, California
City of Santa Barbara, California
City of Saratoga, California; and others

Through the Solar Leasing Program, Oceanside is generating local economic development and decreasing conventional energy use and costs via the use of private investment capital. The Program is being developed because of the current administration's emphasis on local self-reliance, and the use of private capital for new services. The Leasing Program would not exist if the federal 15% Energy Investment Tax Credit is reduced or terminated - simply, there would be no incentive to attract or maintain private investment capital.

The City has attracted over twenty million dollars in energy equipment in 1981 for this project. The City stands to collect in user-revenues approximately three million dollars over five years while reducing energy costs to its citizens by approximately three and a half million dollars.

Because of the 15% Tax Credit, investors buy solar energy equipment and make it available for lease through the City's Municipal Solar Utility. The net effective monthly lease payments for the solar energy system is $11.25, which supplies more than 60% of the domestic hot water needs. A comparable gas fired system would cost the user at least $18.00, and an electric customer would pay above $30.00 a month.

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The 15% investment credit has therefore: 1) created a substantial energy savings to the residents of the City of Oceanside - and consequently saved them money; 2) reduced demand for imported fossil fuels (most of San Diego's electric power is generated with oil and gas); 3) provided local employment in both manufacturing and service industries; and 4) created revenue for the municipality.

The above issues demonstrate the need for continuation of the 15% Business Energy Credit as a tax incentive. By using the MSU as an example of how these credits directly caused a substantial program to happen - one not federally funded - it is easy to see that the net benefit in jobs, manufacturing, and revenue far outweighs the effect to the U.S. Treasury. Clearly, if the 15% credit is abolished, this City's Program, and many other programs just getting off the ground, would end immediately.

STATEMENT OF

JOHN R. IRMSCHER
PRESIDENT AND CHIEF EXECUTIVE OFFICER
EMPIRE FAMILY RESTAURANTS, INC.
CELINA, OHIO

RELATING TO

PROPOSED RESTRICTIONS ON TAX EXEMPT BONDS FOR PRIVATE ACTIVITIES

SUBMITTED TO THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

March 30, 1982

SUMMARY OF PRINCIPAL POINTS

Without tax exempt financing, Empire Family Restaurants, Inc. would be in a very precarious position. We currently have nine restaurants (our newest in Napoleon, Ohio financed with Farmers Home Loan) and a food processing plant that was recently built with Industrial Revenue Bonds. We employ 550 people, of which 95% are unskilled.

Due to the current cost of capital, Empire has postponed any future restaurant expansion since the spring of 1980. Empire has retained a legal firm and special accounting firm to review our situation. The results of their study have shown we need IDB financing coupled with a limited partnership to enable us to lower our cost of money to a reasonable rate. With this system just being currently devised, it stands in the shadow of disaster if the Federal government abolishes IDB financing.

Being a small business starting in 1966 with two shareholders, Edward McGillvary and myself, we achieved financing through a local bank (100% financing). As we started to grow in 1969, we used the Small Business Administration to assist us and then went back to conventional financing. In 1979 we used IDB financing for our food processing plant and have gone from leasing our restaurants to financing with Farmers Home Loan for our newest restaurant in Napoleon.

Our food processing plant was built with capabilities for future growth. We need that future growth to help finance the cost of the food processing plant. As you can see, an IDB is not a luxury but a necessity.

TESTIMONY OF MR. JOHN R. IRMSCHER
EMPIRE FAMILY RESTAURANTS, INC.
136 NORTH ENTERPRISE STREET
CELINA, OHIO 45822

I appreciate the opportunity to present our feelings before the Committee and describe the essential role Industrial Revenue Bond financing plays in our needs for the future.

Empire Family Restaurants is a privately held company with two shareholders, Edward McGillvary and myself. Empire was started in 1966 and has grown to nine restaurants in Ohio (Celina, Urbana, Troy, Greenville, Piqua, Van Wert, Englewood, Sidney and Napoleon). We also own and operate a Federally inspected food processing plant which was financed with Industrial Revenue Bonds. This facility supplies food to our restaurants and manufactures a retail product in a boil pouch bag. The development of the retail business was out of necessity rather than design. Our growth was stymied because of the high cost of money, and entry into the retail business was designed to generate additional revenue to cover the cost of this new food processing plant.

Prior to 1980 our restaurants were leased from private investors but when the cost of money went up, we purchased our Napoleon, Ohio restaurant with Farmers Home Loan, which helped us keep down the cost. We find it impractical to lease from investors because we need to pay them 2% - 3% over their borrowed cost. This means with today's money we would have to pay 19 1/2% - 20 1/2% on the total capital cost of the project and this is unreasonable.

In looking at our peculiar situation, we contacted one large accounting firm and a legal firm specializing in Industrial Revenue Bonds and limited partnerships. The outcome of that meeting was to help us finance further restaurants by developing limited partnerships integrated with Industrial Revenue Bonds.

To be able to show a profit, anything over a 12% - 13% interest rate would be prohibitive. As small businessmen, we are concerned about survival as well as growth.

We feel that you hear negatives about IDB's from individuals and small business people about the large corporations in our industry, such as McDonald's and Wendy's, that maybe you feel this should be abandoned. Instead of being abandoned, I feel the IDB system is a necessity in the current economic conditions if you want any growth at all. Don't solve your problems by just eliminating, but investigate how this vehicle can be refined and impose controls on overuse and abuse.

Our problem as small businessmen is that large corporations have been using IDB's and are able to obtain a better interest rate. By taking it away, the problems worsen for the small businessman. You can look at our particular case or any small business and find that eliminating this vehicle will definitely stop our growth and create further problems. This would just slow the growth rate of large corporations, but in our case, you may actually kill us.

In our case, if we want to continue to grow, we must take cash from repairs, maintenance and remodeling to keep customers and stay competitive with large corporations.1/

The other key factor in our industry is that with large corporations expanding and the prime real estate locations being picked up, it has greatly inflated the cost of that piece of commercial property. With the high cost of money on top of that, it further compounds our problem in our industry for the small businessman.

As I continually talk about inflation and of competition increasing the cost of real estate, let's look at an example that has happened to our industry. Basically, up to 1973 our capital cost did not increase very rapidly. From 1973, for an acre of property in a small community of 8,000 - 18,000 population (in which we operate), the cost of land has gone from $35,000 to approximately $100,000. The cost of a 4,000 - 4,500 square foot building has gone from

$108,000 - $115,000 to over $300,000. The rate of interest has gone from 8% to 17 1/2% for commercial money.

We also have received help from the Federal government as we used Small Business Administration, Farmers Home Loans and Industrial Revenue Bonds as we started growing in 1969.

One of the key systems to our growth and survival are Industrial Revenue Bonds. We continually hear government saying the strength and welfare of this country depends a lot on the small businessman. We agree with that and see things that discourage us. We see huge corporations closing their doors and letting hundreds and hundreds of employees go. They want small businesses to come in and buy the facility and put people back to work. The small business has been loyal to the people of this country. So how about giving the small business a break.

We tend to try to make rules so simple that you write one for everyone, but there should be some feeling for different segments of the industry. Please don't axe this program. If you need to amend, pay attention and listen to different people in the industry. Judge the facts and make the best decisions from these facts and not outside pressures that don't have the actual data. I'm confident that with facts you will keep the

Industrial Revenue Bonds and encourage some benefits for the small businessman in that IDB package.

Also enclosed is a profit performance and cash flow statement using three examples:

A. Our current restaurant in Napoleon using Farmers Home Loan at 12%.

B. Financing same project with current 17 1/2% interest rate.

C. Leasing from private investor with current interest rate.

Results will show that it is not a luxury if we used IDB's, but without it we would be unable to make a profit.

I'm showing you proof instead of hearsay and am flatly stating that we cannot expand without using IDB financing.

John Irmscher - Proud to be an American

1/ In addition to our industry being capital intensive, it is also labor intensive. We also employ unskilled persons, and being labor intensive, one restaurant alone employs 50-60 people. These categories of employment would be: (a) waitresses, (b) cooks, (c) dishwashers, (d) hostesses and (e) cashiers.

EMPIRE
FAMILY RESTAURANTS, INC.

GENERAL OFFICE
136 NORTH ENTERPRISE ST., P.O. BOX 800 - CELINA, OHIO 45822
PHONE (419) 586-7736

RESTAURANTS LOCATED
CELINA
ENGLEWOOD
GREENVILLE
PIQUA
SIDNEY
TROY
URBANA
VAN WERT
NAPOLEON

RESTAURANT PROJECTION	A.	B.	C.
Sales	$675,000	$675,000	$675,000
Fixed Expenses			
Manager Salaries	28,600	28,600	28,600
Accounting	18,200	18,200	18,200
P.P. & R.E. Taxes	2,925	2,925	2,925
Liab. & Prop. Insurance	2,170	2,170	2,170
Bldg. Depreciation	*8,750	*8,750	0
Equip. Depreciation	**15,000	**15,000	**15,000
Interest - Bldg. & Land	51,600	75,250	0
Interest - Equipment	18,000	26,250	26,250
Rent	0	0	83,850
	145,245	177,145	176,995
Variable Expenses	519,278	519,278	519,278
Total Expenses	664,523	696,423	696,273
Profit/Loss	10,477	(21,423)	(21,273)

EXAMPLE A.: Financing is at 12% (FMHA). Interest shown is first year interest.
EXAMPLE B.: Financing is at 17.5% (Conventional). Interest shown is first year interest.
EXAMPLE C.: Building & land are leased at 2% above the investor's mortgage rate of 17.5%.
* Building Cost of $350,000 is depreciated over 40 years.
Land cost is $80,000.
** Equipment Cost of $150,000 is depreciated over 10 years.

Variable Expenses	
Food	35.50%
Labor	18.70
Managers' Bonus	3.90
Janitor Expense	1.40
Administrative Fee	2.75
Advertising	1.78
Restaurant Supplies	.60
Equip. & Bldg. Repairs	1.05
Dishwashing Supplies	.40
Linen & Door mats	.31
Utilities (electric, gas, water, sewer, garbage, phone)	4.03
Cleaning supplies & carpet cleaning	.70
Guest check & menus	.29
Uniforms	.41
Payroll taxes	3.61
Cash short, travel, misc.	.20
Employees Fringes	1.30
	76.93%

CASH FLOW	A.	B.	C.
Sales	$675,000	$675,000	$675,000
Profit	10,477	(21,423)	(21,273)
Bldg. Depreciation	8,750	8,750	
Equipment Depreciation	15,000	15,000	15,000
Cash Flow	34,227	2,327	(5,273)

NOTE: When leasing, we normally pay the investor 2% over his mortgage cost. As the example show, with interest rates of 17.5%, this is unrealistic for us.

UNITED STATES SENATE COMMITTEE ON FINANCE

WRITTEN STATEMENT
OF
GEORGE W. CREGG, C.I.D.
ON
EXEMPT SMALL ISSUE
INDUSTRIAL DEVELOPMENT BONDS
FOR THE
HEARING RECORD OF MARCH 17, 1982

INTRODUCTION

Alexander Hamilton in the New York Packet, Tuesday, January 1, 1788, wrote, "In DISQUISTIONS of every kind, there are certain primary truths, or first principles, upon which all subsequent reasonings must depend".

On another occasion in the Federalist Papers he stated:

> "The individual States should possess an independent and uncontrollable authority to issue their own revenues for the supply of their own wants."

The Federalist system endorsed the doctrine of recprocal immunity. "The powers not delegated to the United States by the Constitution or prohibited by it to the States, are reserved to the States respectively, or to the people" Article The Tenth, Constitution of the United States.

Under the New Federalism of 1982, powers and responsibilities unsurped over the last 50 years of wars and social change should be legally returned to the States.

GENERAL COMMENTS

Hamilton said, "Men, upon too many occasions, do not give their own understandings fair play; but, yielding to some untoward bias, they entangle themselves in words and confound themselves in subtleties". (Emphasis our) The TREASURY DEPARTMENTS'S GENERAL AND TECHNICAL EXPLANATIONS OF TAX REVISIONS AND IMPROVED COLLECTION AND ENFORCEMENT PROPOSALS contains an abuse of "fairplay" and "untoward bias" that would have shocked Hamilton in spite of his strong preference for a national instead of a federal government.

The section entitled "Tax-Exempt Bonds for Private Activities" is cleverly written in a manner used by many lawyers in writing pleadings and briefs designed to prejudice a court or jury by the use of "labels", "catch phrases", "unfounded conclusions", "spurious assumptions", etc. While I have great respect for the Federal Treasury Department's tax collecting ability, tax policy and economic policy should be made by the Legislative Branch of our Government subject only to the veto of the President. The laws implementing that policy should be interpreted by the Judicial Branch, and enforced by the Executive Branch. Under such circumstances, a report to the Congress such as this document should state unprejudiced facts without the intentional use of emotional and biased words or phrases. The Congressional Budget Office report was fairly entitled "Small Issue Industrial Revenue Bonds" and released April 1, 1981 and prepared under the CBO's mandate to provide nonpartisan analysis with "Policy Alternatives" and "Policy Goals"; not the unfair biased "Proposal Limits" contained in the subject section. The Treasury should have entitled this section "Industrial Development Bonds" and not "Tax-Exempt Bonds for Private Activities". The "public purpose" behind the continuance of the constitutional right of States and their subdivisions to issue Industrial Development Bonds is to encourage the economic development of the whole United States. The exemption from taxation of the interest on such bonds under qualifying circumstances provides not only an incentive for the retention and creation of jobs, but also acts as a strong incentive to modernize the backbone of our small (10 million is small - one U.S. Army tank costs over 2 million) industrial plants, and revitalize our urban areas. The use of the phrase "Private Activities" ignores the "Public Benefit" nature of such financings in bringing about the expansion and development of the economy.

Under the section subtitle "Reasons for Change" (which assumes there are such reasons "for" and none "against"), highlights a growth erroneously preceived as "bad" rather than "good". The growth is good and is a barometer measurement of an improvement in the economic climate. In the second sentence of this subtitle, the "largest growth" is stated to have occurred "in small issue IDB's; implying the "largest" is the "worst". This growth should be no surprise to the Treasury which has successfully blocked the ablility of small business to borrow conventional loans at "reasonable" rates. Treasury obligations issued in great volume in the last few years has skyrocketed interest rates. Reduce federal borrowing and reduce federal spending, let interest rates drop to 6 to 8 percent (7 percent is prevalent in Japan) and small business will return to the conventional market.

The national rate of delinquency on payments on loans from the Farm Home Administration is now at 58%. If you restrict the right of a State agency to issue industrial development bonds, instead of small business expansion you will have small business collapse. Farmers and other who in the past have sought small business jobs in manufacturing during agricultural recessions will have no place to find work. Students graduating and other youths will have no productive future. Welfare expenses and the costs of crime will increase.

The nation's economy is extremely fragile and cannot stand tinkering. Henry Kaufman, well known economist, testified before the House Committee on the Budget on March 16, 1982:

> In closing, I again want to urge you to implement economic policies that will deal effectively with the gravity of the business and financial situation. Patchwork policies will not resolve our problems. Basic reforms in both fiscal and monetary policies are needed. Without them, not only will sustainable economic recovery elude us but greater economic risks may be the consequence." (Emphasis ours)

As Mr. Kaufman pointed our, the credit needs of our Federal Government are now at 28% of the credit market; almost 5 times the demand of the comparable 6% in the 1950's and 1960's. Assuming a current inflation rate of 8%, Mr. Kaufman said "the real rate of return is now about 800 basis points for high-quality corporate bonds -- a postwar record", and indicated that in the 1960's and 1970's "these returns averaged only 275 and 206 basis points, respectively". Mr. Kaufman said, "High 'real interest rates' are dangerous to the seriously weakened financial structures in the private sector..." Some of our big energy companies can still go to the credit market and obtain sufficient money to speculate in huge mergers; money is still available if the risk is small and the borrower is willing to, and can, pay high interest rates. The availability of money is recognized in the last sentence of this subtitle, just before the "Proposal" subtitle with this statement "they are able to raise funds readily in capital markets". The Treasury does not add "at 16%".

The relatively small businesses need tax-exempt rates in order to obtain the money needed to modernize our industrial complex. The fourth sentence in the subtitle "Reasons for Change" indicates the sale of IDB's "affects the market for tax exempt securities as a whole" when the Treasury well knows the real problem is the 28% credit demand of the Federal Government, and not the "minimal affect" of small issue IDB's in the competition for "traditional private corporate capital" which is always expanding. The competion is not with "traditional municipal bonds". In my humble opinion, one month of "all-savers" certificates would have more effect on the municipal credit market than all the small issue IDB's issued to date. Numerous other laws including Glass Steagal, and foreign tax credits have very serious effects on the "traditional municipal" credit market. One unmentioned fact in this subtitle on influencing all interest rates is the unpredictability of Federal monetary policy.

The viability of Industrial Development Bonds is recognized throughout the United States. These Bonds have proven to be the best and most useful tool available for the industrial and any other kind of economic development. If we want to expand and modernize, if we want the kind of capital investment that will compete in todays world markets, we must start by keeping the few incentives that are working. Let the States continue their work unhampered. It is good for our States' economies and for our Nation's economy. It will be good for the economy of the free world. The tax exempt feature of IDB's not only upholds the relationship of State and Federal Governments mandated by our Constitution, it promotes fiscal independence of the States. Local units of government have always been closer to the people and are in the best position to determine their own public policies. States should be allowed to continue to use IDB's to pursue these goals.

The great State of Massachusetts through its Massachusetts Industrial Financing Agency recently completed a study which surveyed 800 of the bay State's firms that have issued more than 1 billion in IDB's since 1978 and found these bonds contributed greatly to the ability of small companies to expand. The results were certified by a nationally known accounting firm. More than three-quarters of the firms assested had sales of less than $20 million while almost half were under $5 million. 93% of the companies said they would have been forced to alter their investment plans in IDB's were not available. 33 1/3% claimed they would have cancelled their expansion plans; nearly another third said their expansion would have been delayed; 1/5th said their project would have been slashed; and 5% said they would have located in another State. The incentive is to modernize and expand; not locational.

In October of 1981 a similar, study was completed on the "Primary and Secondary Impacts of IDA Financing on the Long Island Economy". The Long Island study concludes, as follows:

> "The Federal government, through IDA financing, can make a major contribution to the growth and viability of the Long Island economy. Based on IDA bonds issued during the 1980-81 period, the Federal government would lose $48,993,250 in interest foregone on IDA bonds issued in Nassau and Suffolk counties. However, the Federal government would gain $396,096,610 in income taxes on direct jobs created and $1,188,221,526 in income taxes on secondary jobs created over a ten-year period. In addition, there would be substantial increases in state income taxes, in state and local sales taxes and in local property taxes".

In the 1976 a study was prepared for the American Industrial Development Council (now the American Economic Development Council, Inc.) by Dr. John A. Andrews and Dr. Dennis R. Murphy of Emory University entitled "The Interest Tax-Exemption on Industrial Development Bonds: The

Cost To The United States Treasury" which reached substantially the same conclusion as the recent Long Island survey. The Emory University study stated as follows:

> "The issuer is not the only party that benefits from the issue of the securities. Since the primary use of the funds is to acquire or improve depreciable property, there will be an economic benefit to the related trades that support the depreciable property in the form of wages, salaries and so on. Beyond this initial stimulus, there is a long term benefit to the immediate area in the from of creation of jobs, resulting in wages, salaries and commissions that in turn create additional activity".

Furthermore the Emory University study concluded:

> "It is clear from the foregoing analysis that previous studies have seriously overstated the net costs to the Treasury because of the tax-exempt interest payable on the IRB's. It is very difficult to argue for the removal of the tax exemption on IRB's on the grounds of the cost to the Treasury in terms of foregone tax revenues."

Dr. Norman B. Ture, in his 1980 study "Economics and Federal Revenues Effects of changes in the Small Issue Industrial Development Bond Provisions" noted that projection of a revenue loss are based on the unrealistic assumption that there are no changes in economic activity in response to a tax change, and concluded that the Federal government would receive a significant revenue gain from increased use of IDB's based upon the increased capital formation with the secondary gains in output, expansion of corporate tax base; and increased individual FICA and income taxes, and corporate payroll taxes. He concluded that increasing the "capital expenditure limit" on IDB's "would generate net gains in tax revenues for the Federal government and for the state and local governments of the issuing jurisdictions."

The New York State Economic Development Council in 1981 undertook its own study of IDB financing in New York State. This study is still under way and is not yet complete. An interim report reviewing replies from 33 of the State of New York's Industrial Development Agencies concluded:

> "The majority of IDA's do not believe the present bond limit is satisfactory but not all agree on what the limit should be. Eight IDA's thought the limit should be $20 million."

ANALYSIS OF TREASURY PROPOSALS

Proposal (1)

There is no need for any such proposal in New York State. The New York State Industrial Development Agency Act clearly defines "public purpose", all meetings of the Agencies are subject to the State's Open Meetings Law", a majority of all the authorized members must act to approve a bond issue, and the members are "appointed by the governing body of the municipality" and shall serve "at the pleasure of the appointing authority". New York's Industrial Development Agencies are well run and adhere to "public purpose" financings. Only 2 small issues have gone into default in over 12 years, and over one and one-quarter billion in financing. The small businesses of New York State have truly been served, and the public purpose of creating and retaining jobs has been fulfilled. Approvals of the elected officials would create serious problems regarding possible individual or municipal liability.

Proposal (2)

New York State's Constitution prohibits gifts or loans to private enterprises. New York would have difficulty with this proposal. On the other hand, New York does allow a long list of tax advantages to industry and business without discriminating as to whether the company involved is seeking tax exempt interest. However, it should be noted that the interest on IDB's is totally tax exempt in New York State with no capital expenditure rule. Most projects are exempt from Sales Tax. The real property is tax exempt though payments are usually made in lieu of taxes. There is no personal property tax in New York State. To require more would be unfair to New York.

Proposal (3)

To require 35 year "extended" life straight line depreciation is obviously proposed to wipe out IDB financing and totally unfair.

Proposal (4)

No change is needed to "help" small businesses in this regard. The Congressional Budget Office report indicates "only 16 percent" of such financings were for Fortune 1000 or 50 companies, and 84 percent were small business.

Proposal (5)

The newest trend in order to react to the lingering recession is to pool resources, and to start up (1) industrial condominums in urban areas and (2) small industrial parks in suburban and rural areas. To do this requires composite letters of credit and guarantees. Proposal 5 discriminates against small business at one of its most recent darkest hour.

Proposal (6)

Registration will increase the cost of issuance, cost of operation of Agencies issuing agencies and result in still higher interest rates. This proposal also discriminates against small business. In New York issues are reasonably and accurately reported to the New York State Department of Commerce even though there is no requirement to do so.

Proposal (7)

The present arbitrage regulations are difficult enough to comply with. The typical New York project has no "reserve fund". However the difficulty of calculating and planning a "zero return" on a temporary construction fund would be impossible. Any such requirement would severely complicate an already expensive procedure and again discriminate against small business in New York State.

Proposal (8)

No comment.

CONCLUSION

America as a nation is dying of "old age". Our infrastructure is decayed. Our bridges, highways and other public facilities are falling apart. Eighty percent of our industrial establishment is operating in 30 to 40 year old buildings. Many of our industrial workers are using World War II machines and tools.

Hiroshima has been largely rebuilt twice since the atomic bomb was dropped. We have been lost in lethargy, cliche attacks on "big business", and rampant regulations and restriction of all business.

As an industrial and economic developer, I know the tools that are useful for modernizing our economy. I am not a theroist.

Industrial Revenue Bonds are under attack because of a mistaken idea that only big-name rich companies benefit at the expense of the taxpayer. The use of a few well known trade names, the listing of a few "abuses" and totalizing volumes of dollars all make for sensational press headlines. However, as responsible representatives of the citizens of our communities, our States and our great Nation, we must examine the true facts in assessing best approach to our rapidly declining position in the World's economy. The economic war between the States is almost over. While a few small areas of our nation are experiencing old fashioned "prosperity", double-digit unemployment is pervading almost every other corner of our great United States, we must act in a very positive way to seek out the causes of our weakening economy. Our close friends in West Germany and Japan have built modern industrial empires. The Communist countries are moving at a relatively slow pace, but they started their "five year programs" of economic expansion from scratch and have been maintaining enormous military budgets. The biggest threat to our economic future is from the middle east. They will be our "friends" as long as we buy their oil, and "subsidize" both their economic development and military budgets.

Richard Henry Lee, author of the resolution of June 7, 1776 calling for independence from Great Britain is known to have said that our great U.S. Constitution was "calculated ultimately to make the states a consolidated government." Patrick Henry supported Lee's belief. The spirit President Reagan's "New Federalism" is the return of control in fiscal matters to the States.

Alexander Hamilton under the pen name of "PUBLIUS" aptly said:

> "Every thing beyond this must be left to the prudence and firmness of the people; who, as they will hold the scales in their own hands, it is to be hoped, will always take care to preserve the constitutional equilibrium between the general and the State governments. Upon this ground, which is

> evidently the true one, it will not be difficult to obivate the objections which have been made to an indefinite power of taxation in the United States".

We have faith in our Senators and our Congressmen as representatives of the people and believe that they will follow the great leadership of our founding fathers in upholding the Constitution and in legislating on a fair and unbiased basis.

Industrial Development Bonds are needed now, more than ever, to save our small businesses and to keep our economy from disaster.

(For additional copies of this statement write George W. Cregg, C.I.D., 932 Onondaga Road, Camillus, New York 13031, or Phone 315-468-1479.)

WRITTEN STATEMENT OF
WILLIAM R. HARRIS, VICE PRESIDENT AND GENERAL MANAGER
INDUSTRIAL CHEMICAL DIVISION
PPG INDUSTRIES, INC.
FOR INCLUSION IN THE RECORD OF
HEARINGS BEFORE THE SENATE COMMITTEE ON FINANCE
MARCH 17 THROUGH MARCH 19, 1982

PPG is a major manufacturer of glass, chemicals, coatings and resins, and fiber glass products, headquartered in Pittsburgh, Pennsylvania. The company operates 41 major manufacturing and research facilities in 17 states, employing approximately 28,000 people nationwide.

As an industrial manufacturer, for which energy is a substantial portion of operating needs and costs, we have a significant interest in legislation which encourages investments in energy-conserving property. In 1980, PPG consumed about 105 trillion BTU's of energy in the manufacture of its products, down from a 1976 total of 139 trillion BTU's. In 1980, our energy efficiency as a corporation had improved more than 23 percent compared to 1972, while production and sales increased.

PPG has faced essentially the same or greater cost increases for energy over these years as has been experienced by the general public. Energy is a substantial cost item to PPG totaling approximately $187 million in 1981. However, it is not our only cost and represents some seven percent of the company's U.S. sales dollars. Therefore, although energy costs have soared and are expected to increase further, they are still only one important cost item among many. Within a corporation, competition for the capital expenditure dollar for energy saving or other projects must be considered in light of projected economic benefits. Therefore, the blind pursuit of energy conservation for conservation's sake is a luxury PPG, and I suspect most companies, cannot afford in their highly-competitive markets.

While the subject of these hearings is clearly the broad and very complex revenue raising proposal of the Administration, my purpose today is to focus on one small but important part of that package, the business energy tax incentives. PPG believes the elimination of existing energy tax credits is not consistent with the Administration's goals to strengthen the economy, reduce inflation, increase productivity, and stimulate capital formation for further productive investment.

History of Tax Credits

The use of tax credits as an incentive to stimulate the modernization of industrial processes used by industry, is a concept well established in our tax system. The use of tax credits was first approved by Congress as part of the Revenue Act of 1962. In 1962, it was noted that American industry must compete in a world of diminishing trade barriers and growing foreign competition, and that an increase in efficiency and productivity at a rate at least equal to that of other leading industrial nations is in the long run necessary, both from the standpoint of U.S. balance of payments and to improve our standard of living.

To deal with these problems, the objectives of the investment credit were to "encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country with a resultant increase in job opportunities and betterment of our competitive position in the world economy." (S. Rept. No. 1881, 87th Cong., 2nd Sess., 1962). These objectives would be realized, it was observed in 1962, by using investment credits to stimulate investment and increase the availability of investment funds. The importance of these goals, and the appropriateness of investment credits for achieving them, are as valid today as they were two decades ago.

Energy Tax Credits

Congress further recognized the incentive potential of investment credits when it enacted the Energy Tax Act of 1978, to utilize energy investment credits as an incentive to encourage industrial energy conversion and conservation. It realized that the Nation's dependency on foreign energy resources posed a serious threat to our economic well-being and our national security. The Congress rightly perceived that energy conservation would make an important contribution to both reduce U.S. dependence on foreign oil supplies and bring energy supply and demand more into balance.

The concept was clear. Given the incentive, industry would spend more funds sooner to reduce its energy dependence. The emphasis was on more and sooner, for, given the importance of energy supply and the rising cost of energy, there is little doubt that where possible the funds would be spent eventually or facilities would be forced to close. The benefit of spending more sooner, however, was clear to Congress. Energy savings would be realized on an accelerated schedule, thereby reducing oil imports and the budgetary and trade impact of these imports.

Under the legislation, Congress considered three main factors. First, they put a limit on the number and types of expenditures that would qualify for the credits. Secondly, focusing on achieving energy savings quickly, a short time period was imposed for realizing the incentive and, thirdly, they limited the incentive to a relatively conservative 10 percent tax credit. Although the favorable results anticipated by Congress have not been fully realized to date, the wisdom of Congress in enacting these energy tax incentives is also as valid today as it was in 1978.

Lack of Treasury Action

The 1978 Act provided for 11 specified items of what is called "specially defined energy property" to qualify for the energy tax credit, and for authority for the Secretary of the Treasury to specify additional qualifying property for tax credits by regulations. To our knowledge, the Secretarial authority given by Congress has not been exercised to qualify a single item in this category despite the fact that these provisions are scheduled to expire at the end of 1982. Proposed regulations were not issued concerning the procedures for applying for qualifications as specially defined energy property until January, 1981, over two years after passage of the Energy Tax Act. Public hearings were held in April of that year, but to date no final regulations have been published.

An Example

The Crude Oil Windfall Profits Tax Act of 1980 added "modifications to alumina electrolytic cells" to the list of specifically defined energy property legislatively, after no action was taken by the I.R.S. on an aluminum industry application. Similarly, PPG attempted to satisfy the administrative requirements for obtaining a determination of eligibility for energy-saving modifications to its chlor-alkali production, which also uses electrolytic cells. Based on the similarity with alumina electrolytic cells, we had also proceeded with an energy conservation program at one of our chlor-alkali facilities with the expectation that this application would be approved. There has been no response.

Improvements in chlor-alkali electrolytic cells save energy in essentially the same manner as the presently eligible alumina electrolytic cell modifications. These improvements are motivated by energy efficiency. They would not increase the productive capacity of the facility and they are not periodic replacements of cell components. The modernization project PPG has underway at one of its chlorine and caustic soda producing facilities, which uses electricity generated by oil and natural gas, will reduce energy consumption by some 460,000 barrels of fuel-oil equivalent each year. The cell modification project represents a single expenditure at one plant of approximately $100 million and, if completed, would result in an energy saving estimated at 25 percent of current energy usage.

We have also calculated that the investment and energy saving would fall within the mid-range of eligibility under the "qualified industrial energy efficiency property" (QIEEP) concept contained in S. 750 on which we previously testified. In addition, S. 2151, which would add modifications to chlor-alkali electrolytic cells to the list of specified energy property under the Energy Tax Act of 1978, has been supported by PPG. Without a favorable Treasury Department ruling or legislative action to specifically make eligible these electrolytic cell improvements for a sufficient period of time to qualify for a credit, this project will be denied the energy tax credits which were anticipated when funding for the project was approved by our Company. In addition, a failure to allow the energy credit for installation of electrolytic cell improvement technology at other PPG plants, and those of others in the chlor-alkali industry, may well result in these energy conservation investments being abandoned. The chlor-alkali industry is the second largest consumer of electricity in the United States.

Conclusion

The argument has been made that the Accelerated Cost Recovery System (ACRS) provisions of the Economic Recovery Tax Act of last year remove the need for energy tax credits to provide incentives for making energy conservation investments. However, a comparison of the application of ACRS and its predecessor, the Asset Depreciation Range (ADR) capital cost recovery systems to chemical industry machinery and equipment, indicates that no significant improvement in the depreciation or cost recovery incentive is provided by ACRS.

The energy tax credit was intended to make energy conservation or conversion investments a little more attractive than other types of investments to those who must make significant investment decisions. This rationale for the energy credit is as applicable today under ACRS as it was under the old ADR system.

The lack of guidelines as to what qualifies, coupled with the approaching December 31, 1982, deadline, has given industry no real signals for making major energy-saving expenditure decisions. In the competition for investment capital, energy-saving projects are competing with other investment opportunities. Management must receive clear signals on what tax credits will or will not be available in order to make these judgments. We recommend that the credit not be repealed, that the definition of qualified property be expanded, and the expiration date be eliminated or extended.

We believe the intent of Congress, when it enacted the Energy Tax Act of 1978, has not been realized, that continuation of energy tax credits is essential to moving the Nation toward greater energy independence, and that credits complement the overall objectives of strengthening the economy, reducing inflation, increasing productivity, and adding to in-place capital formation efforts. We believe energy tax credits pay for themselves, free up generated capital for further investment, and are significant incentives to encourage industry in total to help move our country toward energy self-sufficiency.

My testimony focuses on one small aspect of the Administration's revenue raising proposal with very significant impact on PPG Industries. However, PPG also realizes the importance of reducing the difference between projected federal revenues and expenditures. We believe of greatest importance, in reducing the projected deficit, are ongoing spending reductions throughout the government. On the side of increasing revenue, we believe close attention should be paid to the broad variety of user fees and excise taxes addressed in the Administration's proposal. In addition, the deregulation of natu[illegible] gas, which continues to be discussed in the Congress, offers promise of significant increases in revenue.